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THE INVESTMENT OF LIFE INSURANCE FUNDS

By

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THE INVESTMENT OF LIFE INSURANCE FUNDS

Chapter I

THE IMPORTANCE AND SCOPE OF LIFE INSURANCE INVESTMENTS

I. The Nature of Life Insurance

In those old days when the spark of civilization had first instituted in men the elementary economic concept of division of labor, when all business units were still conducted on a small scale, and when commerce and industry had not traversed beyond the more elementary stages of development, there was no insurance problem for the business entrepreneurs to cope with. With the passage of time, the evolution of business assumed the tendency of greater and greater complications until specialization and coordination become now the order of the day. Concomitant with this phenomenon is the increasing predominance of risk. There are a hundred and one vicissitudes or hazards to which business enterprises of today are exposed. The business or enterprise may be standing firmly on a solid rock and enjoying bright prospects for the future when the man upon whose energetic and capable pivotship the success and stability

of the business depends is suddenly removed by untimely death. The prosperity of a family may at any time be impaired when Providence calls away its breadwinner overnight.

Insurance is incontrovertibly one of the most powerful of all the many institutions that have been devised for the elimination or transference of risks. As Professor S. S. Huebner terms it, it is that branch of economics which covers risk-bearing. The forms in which it appears are many and varied, but all aim to serve the same purpose, and are based upon the same fundamental principle,- that of indemnification of lost values. "Life insurance has for its purpose the financial indemnification of the loss of the life value either for the insured's dependents in the event of premature death, or for the insured himself and his dependents in the event of his reaching the age of retirement from active work." ¹ The essential idea of life insurance is cooperation in the bearing of losses which are likely to happen to any one of a large group of persons, but which are borne by a common fund created through the contributions of the many that are exposed to the same hazard.

¹ S. S. Huebner, "The Services of Insurance," in Journal of American Insurance, September 1925, pp. 5

II. The Importance of Life Insurance Investments to the Insured

Like the capital of other great financial institutions of the modern business world, the funds or assets in the possession of life insurance companies run into millions and billions of dollars. This vast amount of wealth is not wholly kept in their safety vaults where it remains idle, but is invested in interest-bearing or profit-yielding securities or in other remunerative channels.

The paramount importance of such investments to the policyholders becomes clear when we analyze the insurance contract whereby the equity of the insured person is protected. The terms of the policy provides definitely that in consideration of a specified premium and the application, the company promises to pay the full face amount of the policy upon the happening of a certain event. This being true, it is incumbent upon the companies to maintain adequate reserves for the security of policyholders. As there are many different types of policy forms calling for as many different ways of adjusting the claims of the insured or his beneficiary, the subject of reserve, which constitutes the main portion of investments, cannot be overestimated.

In an ordinary sense, the reserve represents the advance premium collections from policyholders, or that portion of the assets held in trust by the company for its policyholders in order to meet the obligations as they mature. As the natural premium plan (in which premiums are increased year after year) has been abrogated, and in its place is substituted the annual level premium plan (in which the amount of premiums remains constant throughout the entire premium-paying period), there is created a reserve fund in the early policy years when claim payments are low and insignificant. This fund in theory belongs to policyholders, inasmuch as it is available to cover the deficit in the later years because of high mortality costs as a result of increasing hazard attached to advancing ages.

The reserve thus constitutes the sole reliance of the policyholders. The security of the insured in placing insurance for providing against old age or for protecting his dependents against the loss of earning capacity occasioned through his untimely death depends largely upon the solvency of the company, which in turn falls back upon the adequacy of the reserve, and the efficiency with which it is maintained, controlled, and invested. Some states have seen fit to pass laws

prescribing minimum reserve requirements with a view to enforcing and supervising the maintenance of adequate legal reserves for the protection of policyholders.

III. The Importance of Life Insurance Investments to the Insurer

To the other party in the contract--the insurer itself, the importance of investments is none the less apparent. One of the peculiar features of the life insurance business is found in the extreme length of time during which a life insurance policy may last. Statistics have shown that the most popular types of contracts in force are twenty-year endowment and whole life policies, the latter, as the term implies, running for the whole of life, or, according to the American Experience Table, to age 96. Consequently the obligation on the part of the company may extend over a long period of two or three scores of years. The funds which are left in its custody must be so invested that it will be able to meet the claims of policyholders when the contract matures, or whenever the insured surrenders the policy for its cash value.

The life insurance contract is a unilateral contract in the sense that the option of cancellation can be exer-

cised only by the insured and not by the insurer. The company is ever confronted with the contingency of paying the amount of the surrender value as stipulated in the policy contract, whenever the insured may elect to lapse the policy after it has been in force for a certain number of years. Failure to fulfill its obligation will jeopardize its credit position and its solvency. It is therefore clear that the importance of life insurance investments to the company itself cannot be questioned.

IV. The Importance of Life Insurance Investments to the Financial World

The mammoth investments of life insurance companies not only reflect their importance to the policyholders and the companies themselves, but also bring out the significant rôle which they play in the financial whirlpool of the business world. It is true that the primary function of life insurance is to afford protection to those who seek it, to hedge against the possible financial losses due to premature death, and to provide against the contingency of old age, but there can be no denial of the fact that the savings and investment feature of life insurance is present and predominant. For whoever

can gainsay that an endowment policy or an ordinary life policy maturing, according to the American Experience Table of Mortality, as an endowment at age 96, does not contain an investment feature, in addition to its insurance function? Directly or indirectly, life insurance companies perform a very distinct service in financing the business enterprises of society, and in exerting a tremendous influence in the upbuilding of the industrial life of a nation.

Directly, life insurance companies, as a recent writer on banking puts it, are intermediaries between the individual savers and the borrowing enterprises of society. They act as "the medium through which a vast aggregation of small sums has been devoted to the furtherance on a large scale of the nation's leading business interests." To this extent they resemble the ordinary savings banks. As savings banks accumulate deposits from multitudes of depositors, so life insurance companies receive premiums from a large group of policyholders. As the funds of savings banks are not idle but are invested, so the funds of life insurance companies are invested in interest or dividend bearing

securities. Like the deposits of savings banks, the premiums of life insurance companies, representing the periodical contributions of a stream of policyholders, are thus transferred to the borrowers or corporations whose securities are purchased for the purpose of investment.

Indirectly life insurance companies also assist in the raising of capital for the financing of multifarious projects. Through the agency of investment banking institutions, they, like savings banks and trust companies, furnish a large portion of fixed capital for business purposes.

Aside from the more or less permanent channels of investments, that is, investment in fixed capital, such as bonds and real estate, life insurance companies play an important part in the extension of funds for temporary productive or consumptive purposes. Occasionally, out of their surplus funds they make short-term loans to business concerns to bridge over short periods of current business needs, and not infrequently they grant policy loans to the policyholders whom they have insured.

The importance of the investments of life insurance

companies to the financial world becomes apparent when we note the magnitude of these investments as compared with the total wealth of the country. The following table shows the nature and volume of the assets of thirty-eight life insurance companies reporting to the Insurance Department of New York for the year 1924:

Real estate	\$146,003,684
Bonds and mortgages	3,465,104,334
Stocks and bonds	3,863,644,281
Collateral loans	4,810,315
Premium notes and loans	1,108,184,803
Cash in office and in bank	79,180,540
Deferred and unpaid premiums	182,772,824
All other assets	159,161,450
Total admitted assets	\$9,008,862,231

From the above table, it will be seen that the total admitted assets for the life insurance companies reporting to the Insurance Department of New York for the year 1924 was in excess of nine billion dollars. Although these figures refer to the status of only thirty-eight companies transacting business in the State of New York, they form the bulk of the total aggregate assets of all the companies in the country. This is due to the fact that most of the largest companies are found in that state. As to the aggregate figures, two hundred and ninety-seven life insurance companies, reported in the

³
The 1925 Insurance Year Book (Life Volume),
pp. A-296.

1925 Insurance Year Book, possess total admitted assets⁴
of \$10,394,034,380 which are distributed as follows:

Real estate owned	\$238,652,554
Real estate mortgages	4,174,768,771
Bonds owned	4,049,231,785
Stocks owned	48,644,006
Collateral loans	18,093,039
Premium notes and loans	1,323,304,728
Cash in office and banks	126,854,800
Net deferred and unpaid prem.	221,049,074
All other assets	193,435,623
Total admitted assets	\$10,394,034,380

It is estimated that this gigantic fund in possession of the life insurance companies is increasing rapidly year by year. An examination of similar figures for the past ten years will reveal the fact that the annual increase has been over half a billion dollars. The figures for 1923, for instance, were \$9,454,620,793, and for 1922, \$8,652,318,490.

Furthermore, it should be noted that of the total admitted assets of life insurance companies about eighty per cent represents investments in real estate mortgages, government and corporate bonds, and stocks. When we realize that stocks and bonds constitute over half of the nation's wealth, we can readily appreciate the financial importance of the investments of life insurance companies

in the upbuilding of the industrial life of the nation, and in the furtherance on a large scale of the nation's leading business interests. The investments of several billion dollars in bonds and stocks are found to be fairly well distributed over the principal transportation and other corporate properties of the country and represent a very substantial part of the total funds that have been necessary for their development. Real estate mortgages likewise represent investments in properties located in all parts of the country. Because of the facilities for obtaining such loans, real estate owners have been enabled to erect buildings or otherwise improve their properties. Indeed "not only have large sums been furnished for the development of cities and towns, but for many years the companies have granted loans upon western and southern farming lands, thus enabling the purchase, stocking, and cultivation of large areas."

Chapter II

THE SOURCES OF LIFE INSURANCE FUNDS

Before discussing the investments of life insurance funds, it is necessary at the outset to examine the sources from which life insurance companies derive their large aggregations of funds. This consideration is an essential prerequisite, for there must be funds first before they can be invested, and the sources from which they come or the forms in which they appear must be known before we can comprehend the methods whereby they are invested.

In sorting out the items which compose the sources of life insurance funds, it is necessary to fall back upon the financial statement or the balance sheet of life insurance companies. In analyzing it, it may be laid down that "every debit balance indicates either an item of disbursements or an item of assets, while every credit balance indicates an item of income or an item of liabilities."⁵ Hence on the credit side of the balance sheet of life insurance companies, we find among

⁵ S. H. Wolfe in his book, "The Examination of Insurance Companies," pp. 134, set down this proposition as a general rule in the examination of insurance companies.

other miscellaneous items the following distinct sources of income, namely: premiums from policyholders, capital stock (in case of stock companies), and surplus.

I. Premiums

First in importance comes premiums, because they form the bulk of funds available for investment. They are simply the sums charged policyholders for the insurance, and represent a stipulated compensation to the insurance company furnishing the protection. Insurance may be viewed as a commodity which commands a price. The seller of the commodity is the insurance company and the buyer the policyholder. Just as there must be full or partial payment for the completion of a sale, so there must be full or partial payment for the insurance before there is an executed contract of insurance. The premium charged of the insured may be fully paid once for all in case the policy is issued on a single premium plan, or partially paid in advance where the level premium basis is used, before there is affected a contract; for the terms of a life insurance policy expressly provide that the premium constitutes a part of the consideration which is one of the essential requisites for the formation of a sound legal contract.

The premiums of a life insurance company appear in one of two ways: (1) premiums from insurance policies, and (2) premiums from annuity contracts. The first form represents the cost of insurance against death; and the second, the cost of protection against survival. In the first case, the hazard or risk insured against is the contingency that the insured may die within a designated period; whereas in the second case, the hazard is the contingency that the annuitant may live too long and outlive his limited amount of income. The nature of the hazard in both instances is different, but the protection furnished is in principle the same, and the company is justified in collecting its due share of compensation for its service.

The manner of paying premiums likewise assumes many forms. Principally they may be paid by a single cash sum or by periodic installments, usually annually, and sometimes semi-annually, quarterly, monthly, or even weekly. Whatever plan it may be, it is assumed that " (1) premiums will be paid in advance; and (2) matured claims will be paid at the end of the policy year in which the policy matures." ⁶ It is apparent that the

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S. S. Huebner, "Life Insurance," pp. 155.

company has in possession of the money for some length of time before it is called upon to pay for claims as they mature. The amount of money held by the company, although insignificant from the viewpoint of the small contributions of each individual policyholder, will aggregate enormous figures when we view the entire group of policyholders as a whole and when the period of observation lasts for many years. Evidently the premiums of the many policyholders constitute a substantial source of the funds which run into investment channels.

The significance of premiums as a source of income is brought to the fore when we realize that they constitute about 80 per cent of the total income, other than the capital stock, of life insurance companies. The combined policy account of two hundred and ninety-seven companies shows for the year 1924 an aggregate insurance in force of more than sixty billions of dollars which include both new business written and old policies in force. The following table will give an idea of the importance of the different types of policies, and confirm the statement made in the preceding chapter that whole life and endowment policies are the most popular

types of contracts in force.⁷

New business written and paid for	\$13,162,445,851
Whole life policies in force	41,903,997,072
Endowment policies in force	12,659,740,017
All other policies in force	9,236,002,661
Total insurance in force	63,779,740,552

The total insurance in force is apportioned among the following kinds of policies:

<u>Kind of policies</u>	<u>Number</u>	<u>Amount</u>
Ordinary policies	22,082,377	\$49,241,424,055
Industrial policies	68,247,642	11,343,740,085
Group policies	<u>38,312</u>	<u>3,194,576,414</u>
Total	90,368,331	\$63,779,740,552

From both the new business written and the existing insurance in force, these same companies reported a total premium income of \$2,122,383,455, apportioned⁸ as follows:

New premiums	\$313,033,507
Renewal premiums	1,785,538,714
Received for annuities	<u>25,811,212</u>
Total premium income	\$2,122,383,455

II. Capital Stock

Another source of life insurance funds which is characteristic of stock companies is found in their

^{7,8} The 1925 Insurance Year Book (Life Volume), pp. 456.

possession of huge amounts of capital stock. Although this item affords no comparison with the periodicity and frequency of premiums, it is nevertheless one of the sources of funds available for investment.

One of the strongest claims for superiority by the stock companies lies in their great financial strength based upon the existence of such capital stock. From an accounting viewpoint, all the capital stock which has been issued and subscribed by the stockholders is a liability of the insurance company. In another aspect, it may be viewed as a source of income to the company itself. It is available for policyholders as an element of financial strength. It is intended to serve as an additional investment for the protection of the claims of the policyholders.

In fact, various statutes have prescribed different amounts of capital stock for life insurance companies which are to be organized on a non-participating basis. The Insurance Law of New York,⁹ for instance, provides a minimum capital stock of one hundred thousand dollars to be fully paid in before a life insurance corporation is authorized to transact business.

⁹
Amasa J. Parker, Jr., "Insurance Law of New York," Article I, Section 12.

For every kind of insurance business, more than one, which it is authorized to transact, an additional capital stock of fifty thousand dollars is further demanded. Besides, a surplus equal to fifty per cent of the capital stock is also required of the corporation at the time of its organization.

The use of the capital stock has been subject to careful regulation. As one consulting actuary remarked, life insurance companies are not permitted to use any of their capital stock for the purpose of establishing their business, that is, for the defrayment of the preliminary expenses of the organization, the establishment of agencies and the purchases of supplies. Obviously the logical consequence would be to treat the capital stock as a source of financial strength to the policyholders. The investment of the capital stock is therefore hedged around with greater restrictions than those which apply ordinarily to surplus funds of the company.

The possibility of regarding the capital stock as a source of funds which may be invested by life insurance companies is clearly indicated in the statutory regulation governing the investment of the capital stock.

Indeed, many of the provisions relating to this phase of the subject are preceded by a statement like the following: "The cash capital of every domestic insurance corporation required to have capital, to the extent of the minimum capital required by law, shall be invested and kept invested in....."

The capital stock of the large life insurance companies represent a significant percentage of their total liabilities. Referring again to the two hundred and ninety-seven companies reported in the Insurance Year Book, we find an aggregate capital stock of \$5,381,747. This sum, together with the surplus, or the amount left after the deduction of real liabilities from the assets, constitutes the surplus to policyholders. Inasmuch as this item reaches as high as a half-billion dollars, as true of the companies referred to, it can be readily inferred that a fairly good portion of the investment return of many companies must have come from this source.

III. Surplus

The third source of funds owned by life insurance companies may be discussed under the name of surplus. It is "that sum which the company has on hand after

deducting the reserve value of its policies and after paying its current expenses and annual death claims."¹⁰

In an analysis of the consolidated statement of a life insurance company we find that surplus is one of the items of liability. On the liability side of the statement, we shall find, among other items, the legal reserve which the company has set up to meet its current obligations. This legal reserve is the mean or midyear reserve. Under that the company may have a special disability reserve, if it gives disability benefits to its policyholders, or a double indemnity reserve, if it writes double indemnity insurance. Besides the reserve, the company may be required to hold funds to meet all the claims contested and all those that have been presented but not paid. Furthermore, there are current expenses which must be met, such as taxes, printing bills, attorneys' fees, which have been due and not yet paid.¹¹ All of these may be designated as real liabilities. Any excess funds left over after setting up the legal reserve liability and after providing for mortality cost and expenses will be dealt with as a surplus.

¹⁰

S. S. Huebner, "Life Insurance," pp. 257

¹¹

C. K. Knight, Lecture Notes on Surplus

This surplus, although often times appearing as a single item on the balance sheet of life insurance companies, consists in reality many forms into which it is split. As Professor C. K. Knight explained, aside from the surplus proper, the following items may¹² go under the name of surplus:

(1) Annual dividend apportioned. The surplus, like the capital stock, is available to policyholders as an element of strength. Where the policies are participating, the policyholders are privileged to receive a part of the surplus earnings of the company in which they are insured. The annual dividend apportioned is simply "the sum set aside annually for the payment of dividends when due." It is called a surplus, because, according to our definition, it is the sum left over after the provision for the legal reserve and the payment of death claims and expenses. Whenever the mortality claims increase, the company may reduce, or even stop, the payment of dividends, thereby decreasing the surplus by that amount.

(2) Deferred dividend apportioned. Like the annual dividend apportioned, the deferred dividend apportioned

¹²

Ibid

is also regarded as a surplus, on the same line of reasoning. It cannot be treated as a real liability for the reason that its payment may not necessarily be made. The company is not bound to make good the dividend.

(3) Special mortality fluctuation reserve. Despite its more or less constant regularity, the rate of mortality may at times be subject to wide fluctuations. The occurrence of an epidemic, for instance, will most assuredly increase the mortality rate. To provide against such contingencies, it behooves the company to set aside a fund which will take care of mortality fluctuations.

(4) Special security value fluctuation reserve. Analogous to the special mortality fluctuation reserve in principle, the special security value fluctuation reserve has reference to that sum of money which is set aside to meet the fluctuations in the value of securities in which the company has invested its funds.

In view of the availability of the surplus as a source of life insurance funds, and in the light of the various forms in which it may be split, the sources from which the surplus is derived are not difficult to see.

The first possible source is found in savings from

mortality. We are conversant with the fact that one of the factors upon which the calculation of premiums is based is a mortality table, and that the use of the table is based upon the assumption that during a year a certain number of insured lives will die. If in the particular company the producers or the agents have been prudent in the selection of policyholders and the medical examiners have been careful in the approval of applications for insurance, the company may be able to experience a lower rate of mortality than that assumed by the table. As a consequence, the company may reap a profit due to mortality salvage. The rate of mortality may fluctuate from year to year, but if the company continues in experiencing a relatively lower degree of mortality, it will be able to accumulate a fairly good surplus which may be laid aside for investment purposes.

Next to savings in mortality is savings in loading. The premium, or the gross or office premium, paid by the insured consists of two parts: the mathematical net premium, which is designed to pay for current mortality cost and to provide for the accumulation of the reserve for the payment of matured claims; and the loading, which covers the expenses and contingencies of the company other than mortality cost and investment expenses. If,

therefore, a company has been so successful in administering its affairs that it is able to effect a saving in the expense loading, it is clear that such a saving constitutes a source of profit which may be credited to the item of surplus. This salvage from loading may be used to pay dividends or included in the surplus account to be invested.

The third source of surplus arises from gains from investment earnings, or excessive interest earnings. In the calculation of premiums, one of the essential facts necessary is the factor of interest. As a certain mortality table is used for the purpose of ascertaining the rate of mortality at each insuring age, so a certain rate of interest, such as three per cent or three and one-half per cent, for participating premiums, is assumed for the purpose of setting the minimum limit which the company can realize on the funds in its possession. If the premium receipts and the reserve funds of the company are invested in such a manner as to earn a net rate of interest in excess of the rate assumed in the premium computation, the excess over that rate is a source of profit. The net rate refers to the rate actually earned, making proper allowance for investment expenses.

Next to the premium income, dividends and interest earnings represent a very substantial form of income of life insurance companies. For the year 1924 the total amount for 297 companies reached as high as \$476,559,949. All the different kinds of surplus are not kept in the idle vaults of the companies, but are invested in the usual manner.

IV. Miscellaneous Funds

Aside from the main sources of life insurance funds, namely, premium income, capital stock, and surplus, there may be mentioned the receipts from rents, which represent \$21,434,264 for the same number of companies under consideration. There are other unusual items of income which may be found from time to time in a company's statement, and which, for the sake of convenience, may be grouped under the category of sundry items. For instance, if a company has, for some reason or other, considered an item as valueless, and marked it off in the profit and loss account, and later recovered the loss in part or in full, the amount so recovered will be treated as ^{an} item of income. Again, if any of the invested assets have been sold or have matured, and have resulted in a profit, such profit will be likewise con-

sidered as a source of income. In both of these cases, the funds received should appear in the income portion of the statements of the companies, and may constitute a source of funds available for investment. The combined figure for the 297 companies show an amount of \$82,412,577 for all the miscellaneous receipts.

To recapitulate, the funds in the possession of life insurance companies are indeed enormous. The total income for the 297 companies reported in the Insurance Year Book amounted to \$2,702,770,623 for the year 1924. This represents only income from premiums, interest, dividend, rental, and other receipts for the current year. When we take into account of the capital stock of about one billion dollars and the accumulated reserve of several billion dollars more, we shall appreciate the gigantic size of the investments of life insurance companies.

Chapter III

PRINCIPLES GOVERNING THE INVESTMENT
OF LIFE INSURANCE FUNDS

We have seen thus far the sources from which life insurance companies derive their funds, and the importance of their investment to the policyholders, the companies, and the economic organization of society at large. As one writer visualizes it, "the financial administration of a life insurance company is governed by the conception of a trust which regards with equal solicitude the interests of the existing policyholders and those of the public who may hereafter participate in its benefits and obligations."¹³

To find proper channels for the funds which have passed into their hands is a serious problem for the executives. The mammoth size of assets which are found in the life insurance business demands skill and capability of high calibre in handling them. An executive, if he would deal with entire justice to every interest concerned, needs the wisdom of a sage. Not only must he be conversant with the internal conditions of his particular business, such as the nature of the risks assumed,

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T. E. Young, "Insurance," pp. 240.

the production of new business, the system of rating, and the adjustment of claims, but also he should observe the trend of the business as a whole and the external influences which affect his business, such as statutory regulations, the stability of the security market, and the cyclical and seasonal fluctuations of general market conditions, because all of these factors exert a powerful influence in the investment policy of the company, as well as the volume of new business. In short, capacity in finance and economy of management of the funds is the heart and core of success.

There can be no hard and fast rules which can be set down in black and white for the strict observance of life insurance companies. The best we can do is to present some of the fundamental principles underlying the investment of life insurance funds, a cognizance of which is undoubtedly of supreme importance that cannot be overestimated. Briefly stated, the primary principles on which life insurance investments should be based comprise the following essential ideas.

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The discussion of the principles governing the investment of life insurance companies is largely based upon the following sources: T. E. Young, "Insurance," pp. 242-245; S. S. Huebner, "Life Insurance," pp. 358-360.

I. Absolute Safety

In the first place, the funds should be invested in such a manner as to insured absolute safety; that is, permanent integrity of capital with the occurrence of the least violent and frequent fluctuations of value. By absolute safety we do not mean that each separate loan will certainly be repaid, but that the funds as a whole will be safe, as will be the case when investment gains off-set losses by a wide margin. The solvency of a company is gauged by the adequacy of the total admitted assets to offset the total liabilities, or more specifically, the sufficiency of the assets to meet real liabilities. Its reserve is regarded as an indication of the solvent condition. When it is impaired, the solvency of the company is jeopardized to that extent. Likewise, the capital and surplus constitute the surplus to the policyholders. When they are mismanaged, the financial strength to the policyholders is shaken. The company must invest the reserve accumulated under the different policies and the capital and surplus in such a way that the safety of the investment will be absolutely guaranteed.

This requisite is not only important to the solvency

of the company but also to the security of the policyholders. Once they have secured a policy in a bona fide way, and as long as they pay their premiums regularly, they can lay claims upon the insurance company whenever their policies mature according to the terms of the contract. The equity of their claims depends upon the solvency of the company, which in turn is dependent upon the security of the capital that has been invested.

II. Maximum Return

Secondly, and subordinate to the first principle, the funds should be invested in securities which will bring in the maximum remunerative return. The executives, to whom the task of placing the investment of funds is delegated, should elect those securities which will not only yield a return equivalent to at least the rate assumed in the computation of premiums, which, in the case of participating policies, is fixed at 3% or 3½%, but also earn as high a rate of interest as possible. From the company's viewpoint, larger interest earnings will mean greater profit. The policyholders may likewise be benefited, as their cost of insurance may be reduced, and the dividends declared to the participating policyholders enlarged.

In an effort to secure remunerative investments, however, the management should by no means submerge the principle of absolute safety. The attainment of the golden mean calls for the highest type of judgment and discretion on the part of those upon whom the work of making investments is devolved.

III. Long Term Investments

Thirdly, a large portion of the funds should be invested in long term securities. The advantages resulting from such a course of procedure are: (1) a lower investment expense in order to maintain the investments, because of the reduced amount of turnover; and (2) a greater yield on account of the superior rate of interest that can be realized on long term investments. This principle accounts for the large volume of bond and mortgage loans shown in the previous tables. With the exception of unusual losses, there needs be no apprehension of any possibility of danger in meeting the obligations of the company.

IV. Short Term Investments

Fourthly, a fair proportion of the funds should be invested in short term securities which can be easily

converted into cash upon short or immediate notice. The growing practice of paying cash surrender values and of making policy loans to policyholders has given rise to a new reserve problem. It is not an uncommon practice for a policyholder, on account of the inability to continue the payment of premium or because of the changed needs of the time, to lapse a policy after it has been in force for several years. Under such circumstances, one of the options available to him is to surrender the policy for its cash value as stipulated in the terms of the contract, or, he may apply for a policy loan; that is, borrow a certain percentage of the surrender value of the policy at a fixed rate of interest. In view of the agreement to grant cash surrender values and policy loans on demand, life insurance companies should maintain a substantial cash reserve and invest a portion of their funds in liquid assets of short term notes, such as commercial paper and acceptances.

V. Small Cash Reserves

Fifthly, life insurance companies may keep very small cash reserves. Unlike commercial banks, they have no deposits subject to withdrawal on demand. Payments are not met until losses are incurred or policies mature.

When payments are made, they usually run in fairly regular and uniform amounts, and can be met out of current receipts of premium income and interest earnings from investments. With the exception of unusual losses and surrender values and policy loans, life insurance companies are free from any fear of demand obligations. Even with regard to these items, they are fairly well taken care of by other sources. The granting of surrender values and policy loans may be subject to a period of restriction, such as sixty or ninety days. Although large payments have to be made in the case of unusual losses, there is usually an interval in which the company is conducting an investigation of the claims, and during which there is ample opportunity for the company to dispose off some of its investments. It is obvious that the company can keep a small cash balance on hand, while investing most of its funds in securities that run for fairly long periods of time in order to reap a higher rate of return.

VI. Wide Distribution

Lastly, there should be a wide distribution of the investment of funds, or a reasonable proportion between the different classes of securities selected. No matter how excellent one's knowledge of the value of securities

may be, there is always some risk of loss within any given security. When a large proportion of the funds is invested in any given security, the risk of loss is great. To cite the illustrative example of T. E. Young when he explained the danger of concentrating all investments in one kind of securities: "assume that a fund possesses a large proportion of the ordinary stocks of railways: a period of financial difficulty in railway administration occurs--the adoption, for example, of electricity in continuous locomotive form; the undue extension of loop lines; the 'watering' of capitals; the pressure generally of expenditure discovered to be unproductive; the increasing keenness of competitive effort--in this event the entire amount of this particular class of holding might be adversely affected; and the depreciation naturally might become serious if the suspicion or alarm of the public merged into panic with its thoughtless sales."¹⁵

If, however, the investments are distributed in a more balanced manner, the benefit resulting from the application of the law of average may be reaped. For in accordance with the theory of probability, the wider the distribution of investments, the less will be the percentage of loss. This is simply an application of the

old adage, "don't put all your eggs in one basket."

By spreading the investments, both as regards their kind and amount, the loss that may befall a particular class of investment may be offset by gains in other classes. Any appreciation in the value of other classes of investments due to increased demand for them by the public will tend to compensate depreciation in a particular security as a result of financial disturbance surrounding the set of securities under consideration, and thus restore the equilibrium without causing a heavy drain on the resources of the company.

Chapter IV.

STATUTORY REGULATION OF INVESTMENTS:

HISTORICAL DEVELOPMENT

I. Reason for Legislation

Ever since the inauguration of the level premium system in the life insurance business, the question of finding suitable investments for the funds which have come under the control of life insurance companies, with a due recognition of the principles governing such investments as above outlined, has not only formed a momentous undertaking for the executives to handle, but also attracted the attention of the government in the field. Not only were the companies themselves interested in keeping their integrity and in maintaining the equity of their policyholders, but also were the different states desirous of adequately protecting both classes of interests.

Indeed it was with this object in view that legislation began to encroach upon the domain of the life insurance field. As Professor Huebner pointed out: "Recognizing the vital relationship between the conservative handling of life insurance funds and the abilities

of the companies to meet obligations which extend over long periods of time, nearly all the states have undertaken to regulate life insurance investments in one form or another.... Most of the legislatures take the position that the companies have undertaken trusts of the greatest importance and that those who are named as beneficiaries thereunder should be protected by law to the fullest extent possible.¹⁶ To this end, many states have enacted laws requiring life insurance companies to invest their funds in securities which will yield a reasonable, if not the best, return, consistent with absolute safety as regards principal and yield, the two most important principles governing investments.

II. Regulation of Investments a Matter of the State

It will be noticed that the power of regulating life insurance investments, like other powers which pertain to the regulation of other phases of the life insurance business, resides with the state. The political system in the United States is such that for some legislative purposes it acts as a single unit--the Federal government, whereas for others it act as forty-

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S. S. Huebner, "Life Insurance," pp. 360.

eight independent autonomous bodies each with absolute powers of its own--the state governments. Among those things which are affairs of the state government is the chartering and control of insurance companies. Consequently, the regulation of the investment of life insurance companies is one of the subjects reserved by the states for independent action by their own legislatures.

This being the case, the necessity for action by so many separate legislative bodies has resulted in a great diversity of legislation. In order to comprehend the present legislation as it exists today, we must go back briefly to a general survey of the past legislation. To review the historical development of the different state regulations in the United States would be an almost endless study, for each state has gone through a separate and distinct program of its own. All that can be attempted here is a consideration of the outstanding national events in the history of the subject.

III. Historical Survey of Statutory Regulation

With this viewⁱⁿ mind, the history of state regulation of investments of life insurance companies in this country

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may be outlined as follows:

V (1) First state control through provisions in corporation charter. The first control exercised by the states over the business of life insurance was through the provisions inserted in the charters of the companies. There were no distinctive insurance laws until 1807. From the very outset, all the companies transacting an insurance business were created under the state charter, and hence came within the control of corporation laws which governed corporate institutions in general.

V (2) Establishment of state insurance departments. It was in 1852 in the state of Massachusetts that a board of insurance commissioners was first established to examine the foreign companies doing business within that state. This was followed by the organization in 1855 of the first state department for the sole purpose of handling insurance matters. In 1859, New York created an insurance department. In 1871, thirteen states had an official designated as the insurance commissioner or superintendent whose sole duty was the

administration of the insurance laws, while twenty other states had the work intrusted to various officials. In 1907, twenty-three states had such departments.

√ (3) Efforts at securing publicity and solvency.

The first attempts at regulation were all directed towards the securing of publicity and solvency. With reference to the laws securing publicity, an annual statement or report of the affairs of the company--the assets and the security behind them--was all that was required. The insurance commissioner merely investigated the companies to see that these statements were correct. To secure solvency, standard reserve laws regulating the investment of the assets were enacted.

√ (4) Investment of capital stock. As L. W. Zartman stated, the earliest laws regulating the investment of the funds of life insurance companies pertained to the investment of capital stock. The question of the reserve was still unknown. The problem was to see that at least a certain amount of the capital stock was paid up and the cash safely invested. New York, for instance, enacted a law in 1849 forbidding any company from commencing business until a cash capital of \$100,000 has been paid in and actually invested either in bonds of

the cities of New York, or of the United States, or in mortgages on cultivated farms in New York worth double the amount for which the same was mortgaged. In 1850 Wisconsin enacted a law limiting the investment of capital stock to United States bonds or mortgage loans on real estate in Wisconsin. New Jersey in 1852 provided that life insurance companies should have a capital of at least \$50,000 half of which must be paid up and invested in bonds of New Jersey cities, or mortgages on New Jersey real estate before beginning business. By the end of the nineteenth century, more than half of the states had regulations concerning the capital stock and its investment, practically all of which partook the nature of the above provisions. To quote the words
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of L. W. Zartman:

Summing up shortly the present laws regulating the capital stock of insurance companies, most of the states require a minimum capital of \$100,000. All the states which have regulations allow this capital to be invested in United States bonds, and in the bonds of the states where the company is located. In general the capital may be invested in real estate loans, the value of the land mortgaged to be double the amount of the loan, and the real estate to be located in the home^{state} of the company. City and town bonds can be purchased and collateral loans made upon the above securities.

These laws regulating the investment of the capital stock are strict, and they have exercised an important influence upon the life insurance business in this country. As a guarantee of good intention and to provide a fund to tide over the first years a paid-up capital safely invested is a requirement of nearly every state for a new company.

(5) Investment of reserve. It should be remembered that when regulations were first made, the necessity for reserves was yet unknown. As the companies gradually began to operate on a more scientific basis and to accumulate funds to meet more fully their obligations, the state statutes required a legal standard reserve, and to maintain its integrity, enacted laws regulating its safe investment.

✓ (6) Limitations on real estate holdings. There were even laws passed regulating the investments of the accumulated funds before reserves were required by the states. Particularly was this true with reference to real estate holdings. New York, as early as 1849, limited the real estate investments of her life insurance companies to four principle conditions, namely: "(a) that which was necessary for the convenient transaction of its business; (b) such as had been mortgaged to the company in good faith by way of security for loans previously contracted or for moneys due; (c) such

as should be conveyed to the company in satisfaction of debts previously contracted in the course of its dealings; (d) such as should be purchased at sales upon judgments, decrees, or mortgages obtained for such debts."¹⁹ Moreover, all real estate obtained from settlement of debts due the company had to be sold within five years.

The act which had for its purpose the restriction of the ownership of real property by life insurance corporations on account of unfortunate experience which companies have had with real estate during depressed business conditions, had formed the basis upon which many subsequent acts of other states were enacted. There were of course minor variations of other statutes from the New York statute of 1849, and also gradual modification of the regulations of the New York state itself, but on the whole the laws regulating real estate investments were strict.

(7) Prescription of character of assets. To go further, different states had attempted to prescribe the character of the assets which were to be owned by life insurance companies. These regulations,²⁰ above noted, were embodied in the charters of the various com-

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Ibid, pp. 156.

panies. To reiterate, the law of New Jersey in 1852 declared that the legal investments for New Jersey companies should be mortgages on real estate in its own state, bonds of the United States, and of a half dozen states. The New York legislature in 1857 permitted investments in United States bonds, in bonds of any state, or in the bonds or stocks of any institution incorporated in New York. Collateral loans could be made upon the above securities. In the same year, the statute of Wisconsin granted power to one of its companies to invest half of the funds in mortgages, and to make loans to its policyholders from time to time. By the end of 1870, the security behind the mortgage loans was in almost all cases real estate at home. California and Iowa allowed investments in the securities of corporations chartered by them, and Kentucky allowed securities of railroads to be purchased, while Illinois permitted investment in the stock of banks in that state. Illinois and Wisconsin furthermore granted their companies which went into other states to transact a life insurance business the right to invest in all of the securities of those states.

(8) Tendency towards greater liberality. The developments in the insurance world during the seventies

led to much legislation concerning the investments of life insurance companies. It was asserted that the failure of half the companies in a decade, with the consequent disappointment and loss to the policyholders, gave an impetus to state regulation which had not been held before. Ever since, there had been a gradual increase of regulation, while modifications of one form or another were not found wanting. Many of the provisions have remained intact.

Perhaps it might be interesting to note some of the changes in the development of legislation since 1870 up to the first decade of the twentieth century. Whereas in 1870 most of the laws limited the purchases of state bonds to their own particular state, by the beginning of the twentieth century, the investment in the bonds of any state was permitted by most of the states. The same broadening of the field was noticeable in investments in city and county bonds. In 1870 only four states allowed investments in corporation securities. Twenty years ago, many states, such as California, Colorado and Utah became so liberal as to permit their companies to invest in the bonds or stocks of any solvent dividend-paying institution other than mining corporations.

Conneticut required that dividends must have been paid on such securities for at least three years preceding the purchase. Also by the beginning of the present century, a number of states had made definite provisions for investments in policy loans up to a certain fixed proportion of the reserve upon the policies; while others allowed companies to make collateral loans under certain restrictions upon the securities which they may purchase outright, usually providing that the market value of the collateral must be at least 20 per cent in excess of the loan.

In short, the tendency on the whole had been to allow the companies a much wider field of investment. State boundaries were overstepped. This movement in the field of insurance legislation from the narrow, unjust policy of restricting insurance investments to a certain field was a very striking one, not primarily for the sake of safety to the companies, but for the purpose of securing a better loan market for the citizens of that state.

Chapter V

STATUTORY REGULATION OF INVESTMENTS:

PRESENT LEGISLATION

The power of regulating life insurance investments, as indicated in the previous chapter, comes directly under the jurisdiction of the state governments. Having traced briefly the historical development of past legislation in this field, it is now in order to present a gist of the provisions which govern the regulation of life insurance investments as they exist today.

The discussion of necessity must be limited to the provisions of the New York law to be followed by the insurance companies transacting business in the State of New York. The reasons for adopting this procedure are two-fold. First, in view of the multiplicity of the different state regulations, which vary in minor details with the different states attempting to regulate the business of life insurance, a presentation of all the existing statutes in this country would require far more space than is available in this paper. Second, the New York law is taken, inasmuch as the provisions therein are typical of those in other states, and an analysis of this law will convey to the reader at least

a general impression of the present system of legislation in this country governing the investment of life insurance funds.

In presenting a discussion of the several types of investments, we shall follow the items which are found in the statements of life insurance companies, and which are reported in the Insurance Year Book. Discussion is also limited to admitted assets. They are that part of the ledger assets which the Insurance Commissioner or the Superintendent of Insurance admits as assets. For a detailed explanation of their nature and relative merits, the several types of assets may be considered conveniently in the order of their importance.

I. Bonds

To begin with, all the states allow or rather require the investment of life insurance funds in bonds, that is, bonded indebtedness of governmental or corporate institutions. With reference to the Insurance Law of New York, section 16 of Article I sets forth the following provisions, which apply to every insurance company organized in the State of New York or licensed to

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do business in that state.

The cash capital of every domestic insurance corporation required to have a capital, to the extent of the minimum capital required by law, shall be invested and kept invested in the stocks or bonds of the United States or of this state, not estimated above their current market value, or in the bonds of a county or incorporated city in this state authorized to be issued by the legislature, not estimated above their par value or their current market value, or in bonds and mortgages on improved unencumbered real property in this city worth fifty per centum more than the amount loaned thereon.

Any domestic insurance corporation may, by the direction and consent of two-thirds of its board, managers or finance committee, invest, by loan or otherwise, any such surplus moneys or funds in the bonds issued by any city, county, town, village or school district of this state, pursuant to any law of this state.

Section 100 of Article II prescribes more specifically the bond investments of life insurance companies as follows:

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Any such corporation (domestic life insurance corporation), in addition to other investments allowed by law, may invest any of its funds in any duly authorized bonds or evidences of debt of any government in which such corporation is transacting business, or of any state, or of any city, county, town, village, school district, municipality or other civil division of any state. Any such corporation not authorized to do business in a

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Amasa J. Parker, Jr., "Insurance Law of New York," 1925, pp. 13-14.

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Ibid, pp. 135.

foreign country but having outstanding policies in favor of residents of such foreign country payable in the currency of such country may invest in the public stocks or bonds of such country or of any political subdivision thereof to an amount not to exceed the amount of the reserve on such policies.

An analysis of these provisions shows that the different kinds of bonds in which a life insurance company should place its investments may be grouped under the category of government bonds.

The principal forms of government bonds are federal, state, and municipal bonds. Federal bonds refer to bonds of the United States government. They are simple obligations having no definite tangible property as security and depending upon the promise of the government to pay. No compulsion can be brought to bear in the event of a breach of promise, because such a promise is not legally an obligation. As one writer amiably puts it, "bonds of the United States government are now held generally for sentimental purposes, their value from an investment standpoint having disappeared."²²

Next to federal bonds are state bonds. These are simply the obligations of the states. They are issued

at very low rate of interest, the credit of the states being very high. In fact, some of the states have no outstanding obligation of any character.

Municipal bonds comprise bonds of counties, cities, villages, townships, school districts and other political subdivisions. Like federal bonds, municipal bonds are issued upon the willingness and ability of the borrower (in this case the municipality) to perform his part of the contract. But unlike federal bonds, compulsion can be brought to bear upon the municipality by the government in case the promise of payment is not made good. The value of municipal bonds largely depends upon the relation which the taxable value of the property in the political unit--the county, the city, the township, the school district, or whatever it may be--²³ bears to the amount of outstanding indebtedness. This is largely due to the fact that the obligations of the issuing municipality are generally met by taxes levied on the people of the particular locality under consideration. For instance, in the case of county, city, and town bonds, in the majority of cases, "a definite, irrevocable tax, sufficient for the liquidation of the

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Ibid, pp. 31.

debt incurred, is levied against all taxable property at the time of the issue of the bonds."²⁴ Consequently, municipal bonds are regarded as an impeachable form of investment.

Aside from government bonds, there is another class of bonds which are recognized as legal investments for life insurance companies. Reference is had to corporate bonds, or bonds issued by private corporations, and include railroad bonds, public service bonds, and industrial bonds.

Railroad bonds constitute probably the largest item in the bond holdings of life insurance companies, because of their extraordinarily desirable features from an investment viewpoint. "Standard railroad bonds not only meet the requirements of safety, but usually run for long periods, yield a fair return, are readily convertible into cash, and in most instances, although subject to considerable market fluctuations, show a tendency to increase in value in the course of years."²⁵

The forms in which railroad bonds appear are numer-

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Stock and Produce Outlines, "Classification and Description of Types of Bonds," pp. 3.

25

S. S. Huebner, "Life Insurance," pp. 364.

ous but most of them show a more or less greater security of capital and interest than the average type of industrial bonds. To take a few illustrations out of the many that may be cited, we might mention the first mortgage bond, the consolidated bond, the collateral trust bond, the equipment or car trust bond, and the sinking fund bond, all of which may be issued by railroad corporations. The security behind a first mortgage bond is the mortgage upon a definite mileage which constitutes its first bonded lien; that of a collateral trust bond, the bonds of the road and some of its systems deposited and placed in a fund for the protection of the particular bond under issue; that of equipment bonds, the direct first mortgage on the equipment of the road; and that of sinking fund bonds, the accumulation of a sinking fund.

Besides assuring security of capital, railroad bonds yield a fairly good return. Unlike industrial securities which show a great tendency of fluctuation, railroad securities yield a fairly constant return from year to year. The service of railroads is indispensable. In time of slack business, the demand for their service will not be curtailed but remain constant. During periods of intensive prosperity, the demand may increase

slightly, but not so perceptibly as the demand for industrial commodities. The stability of railroad earnings largely accounts for the large holdings of railroad securities by life insurance companies.

Railroad bonds also show a tendency to increase in value in the course of years. In this respect, it is necessary to note whether the bonds contain an option of redemption. If a bond is purchased at a premium, the redemption must be taken into account in determining the real value of the investment; whereas if the bond is purchased at a discount, the option of redemption may be disregarded.

Another class of corporate securities which may be invested in by life insurance companies goes under the name of public service bonds. These are securities issued by public service corporations, which, as their name implies, deal exclusively in those things used for public service purposes. Reference is had in the bonds of water companies, trolley companies, gas companies, and electric companies. Such securities, if the corporation issuing them is well managed, will show a greater stability of earning power than the securities of average industrial corporations, inasmuch as the earnings

of public service corporations are largely independent of general business and industrial conditions. Their value, however, depends upon the franchises which these corporations enjoy, the bonded indebtedness and the density of the population of the localities in which they render their service.

The last class of corporate bonds consists of industrial bonds. They are bonded indebtedness of industrial corporations, as those of the United States Steel Corporation and the American Smelting and Refining Company. Today, side by side with rails, industrial bonds command a great position in the New York Stock Exchange. These industrial bonds are not regarded with much favor by life insurance companies because of their great fluctuations in value. The earnings of industrial corporations depend largely upon general business and industrial conditions, and hence are subject to the fluctuations of the market.

II. Real Estate Mortgages

Second only perhaps to bond investments, real estate mortgages constitute the most important form of assets of life insurance companies. The amount of this class

of investments represents nearly two-fifths of the total admitted assets of these companies. In order to understand their importance, it is necessary, first, to explain the nature of such investments, and, second, to analyze the law of New York relative to their regulation.

A mortgage, as construed in New York, is a lien upon a piece of property given to secure a debt. In view of the large size of loans made by life insurance companies on the mortgage of real estate as collateral for securing the indebtedness, the function of making such investments is intrusted in a board of directors, or a finance committee, or, as in some large companies, a real estate loan department. In order that the functionary in charge of the duty may pass intelligently upon the granting of the loan, certain basic detailed facts regarding the property to be mortgaged must be known, such as the true rental value, the value of the land and the building, and the duration of the construction of the building. The value of the property should be appraised by some disinterested and competent person. The loan will not be made until the margin of safety between the value of the property and the loan has been ascertained.

This margin varies in the statutes of different

states. In New York, it is provided that:

A domestic life insurance corporation may loan upon the security of unencumbered real property in any state worth fifty per centum more than the amount loaned thereon; but real property shall not be deemed to be encumbered within the meaning of this section, by reason of the existence of instruments reserving mineral, oil or timber rights, rights of way, sewer rights, rights in walls, nor by reason of building restrictions, or other restrictive covenants, nor when such real property is subject to lease under which rents or profits are reserved to the owner provided that the security for such a loan is a first lien upon such real property and that there is no condition or right of re-entry or forfeiture, under which such lien can be cut off, subordinated or otherwise disturbed.

The important point to be noted is that the loan on real estate mortgages must be limited to only one half of the appraised value of the property given as security. Or, what amounts to the same thing, the real estate mortgaged to the company as security for loans should be worth double the amount of such loans. This part of the provision aims to protect the equity of the company. Whenever the payment of the loan is defaulted, the company can seize at once the mortgaged real estate in satisfaction of its claims. It is only when the value of the security is in excess of the amount on the loans that the company can be fully reimbursed.

Another outstanding fact to be noticed from the provision is that the loan on real estate mortgages, in order to protect the lender to the fullest extent possible, must be free from encumbrances. As defined by the law, encumbrances should not be construed to mean the depriving of the rights of the owner of the property, such as mineral and oil rights, or rents and profits which he may acquire upon the lease of the property. The term does mean, however, that the loan on real estate mortgages must be a first lien or claim on the property. In case of foreclosure proceedings, the insurance company should be the first to be reimbursed with the proceeds of the sale before the claim of the other creditors is satisfied.

Besides stressing the absence of all encumbrances on the property, some companies require that the making of loans of such character should be limited to improved property which is available for general and not special uses. Examples of property for general uses are ordinary residences and cultivated farms, and those for special uses are hotels, theatres, churches and factories. Consequently the loaning of funds upon unimproved property is generally not tolerated. The value of the buildings as well as that of the land should be considered.

The valuation of the real estate is by no means the only knowledge necessary in order to register a judgment on the making of a loan on such property. Other important facts should be taken into account before a mortgage loan can be safely effected. There must be, above all considerations, an abstract of title, or title insurance policy protecting the mortgagee, showing the validity of the title; that is, the mortgagor has possession of the title at the time the loan is made. Good title, as stated above, refers to whether any prior mortgage has been given or any lien has been recorded against the property. It must find out whether there is any unpaid taxes, unpaid water rent, or any other lien of any kind. All these should be cleared up before the loan is made. Life insurance companies are not permitted to invest in second mortgages, and in order to determine whether the mortgage is a first lien on the property, it is important to ascertain that there are no unpaid taxes or liens recorded against it.

Besides all this supervision, a company which makes investments in mortgage loans should ascertain whether the mortgages are protected against loss by fire. The absence of fire insurance policies will leave the company unprotected in the event of the destruction of the

property and the consequent reduction in its security. There should be fire insurance policies on the property, which should be in solvent, admitted fire insurance companies, and which should contain what is known as the "mortgagee clause." This clause will not only protect the mortgagee against possible loss or damage by fire, but also against the invalidation of the protection by numerous acts of the mortgagor or owner over which he (the mortgagee) has no control.

Thus, except for the necessity of special supervision and of the considerable outlay in the form of investment expenses, real estate mortgages are a desirable form of investment for life insurance companies, because they possess the advantage of a high interest yield combined with great safety.

Generally speaking, mortgage loans are of two principal classes. The more usual group consists of the farm mortgage loans. They are mortgage loans on farm properties. Such mortgages are well known in the West. Because of the vast tract of farm lands in the Western section of the United States, life insurance companies have invested heavily in farm mortgage loans. Such investments are not only favorable to the companies them-

selves, because of remunerative interest returns derived therefrom, but also redound to the benefit of the country at large, because of the facility for procuring funds for the development of large agricultural areas.

The other class of mortgage loans may be grouped under the category of mortgage loans on other than farm properties. It includes all other kinds of mortgage loans, such as city mortgage loans, the security behind which being residences, ordinary buildings, or real estate, located in the city.

The combined total of investments in mortgage loans of life insurance companies constitute a significant portion of the total assets of these companies. In some companies, the proportion reaches as high as 90 per cent, in which case, they are called "mortgage" companies. Whatever may be the justification for such investments, the provisions governing them should be borne in mind if the equity of the company is to be protected.

III. Premium Notes and Policy Loans

Premium notes and policy loans, as a form of investment, are merely the advances granted by a company to its policyholders.

More specifically, a premium note is "a note signed by the insured for his temporary accomodation in order that he may be enabled to pay the premiums called for by his policy contract."²⁷ It is a short term interest-bearing obligation of the insured. Very often the insured, for some reason or another, cannot meet his premium payments in cash. The company generally allows him to pay a part of his premium with an interest-bearing note.

As an asset, premium notes are valuable only as they cancel liabilities, or so long as they do not exceed the reserve value of the policy. In view of the fact that the change in the character of insurance has resulted in the change from premium notes to an all-cash basis, the premium note system has largely fallen into disuse. In fact, today this item is usually treated together with the so-called policy loans.

The Insurance Law of New York appears to be silent on the regulation of premium notes. But in view of their close relation to policy loans, we might pass on to a discussion of the latter, their general nature and

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Definition by S. H. Wolfe in his book, "The Examination of Insurance Companies," pp. 52.

the legal regulations governing them.

A policy loan, it should be understood, is likewise a temporary accomodation which enables the insured to borrow from the company in time of financial need with the policy as security. Instead of surrendering his policy for its cash value and consequently losing the benefit of insurance, the insured may use the proceeds from a policy loan for the payment of premiums which fall due, and thus still keep the policy in force.

The regulation of policy loans granted by life insurance companies is provided in section 16 of Article I of the New York Insurance Law which reads:

Any life insurance company may lend to any policyholder upon the security of the value of his policy a sum not exceeding the lawful reserve which it holds thereon, and such loan shall become due and payable and be satisfied as provided in the loan agreement or policy.

With reference to the loan agreement, one of the standard provisions legally required in the life insurance policy sets forth as follows:

²⁸ Amasa J. Parker, Jr., "Insurance Law of New York," pp. 16

²⁹ Ibid, pp. 137-8

After three full years' premiums have been paid, the company at any time, while the policy is in force, will advance, on proper assignment or pledge of the policy and on the sole security thereof, at a specified rate of interest, a sum equal to, or at the option of the owner of the policy less than, the reserve at the end of the current policy year on the policy and on any dividend additions thereto; and the company will deduct from such loan value any existing indebtedness on the policy and any unpaid balance of the premium for the current policy year, and may collect interest in advance on the loan to the end of the current policy year; which provision may further provide that such loan may be deferred for not exceeding six months after the application therefor is made..... The policy may further provide that if the interest on the loan is not paid when due it shall be added to the existing loan, and shall bear interest at the same rate.

Generally, among the other policy provisions is a table showing in figures the loan values, if any, and the options available under the policy each year upon default in premium payments, during at least the first twenty years of the policy.

From these few provisions it will be seen that the regulation of policy loans by legislation consists of the following essential points:

(a) A policy loan may be a loan on all or a part of the cash value of the policy. The amount of the loan is limited to the reserve value of the policy.

(b) On such a loan the company charges a specified rate of interest, which may be discounted in advance or

paid at the maturity of the loan. In case of any default in the payment of interest, such interest shall be added to the existing loan, and shall also bear the same rate of interest.

(c) The company may delay the granting of the loan until a certain period after the application therefor has elapsed, such as sixty or ninety days, but in no event exceeding six months. Some companies do not have any period of restriction, but allow the loans on demand.

(d) As to the term of a policy loan, it may begin after the policy has been in force three full years, and generally has no definite date of maturity. So long as the insured pays in full his premiums for three years, he may be entitled to the privilege of borrowing from the company. If he should die before the loan is paid off, his beneficiary will be indemnified for that amount of the face value of the policy after deducting therefrom the amount of the loan and the accumulated interest thereon, if any.

From an investment viewpoint, therefore, policy loans are safe and good, as long as they and the accrued interest upon them do not exceed the reserve which the company is maintaining upon the policy. They are, in

fact, advances against cash deposits made by the insured to the company. It will be noticed that in a great many cases the policy becomes automatically cancelled when the outstanding indebtedness against it exceeds the maximum loan value to which it is entitled.

It was further argued that not only the security of policy loans is unquestioned, but also the rate of interest has been good, for the companies have placed it higher than the rate which they have been earning on their other assets. In the fierce competition to secure large amounts of insurance, companies have not been reluctant to grant the privilege to policyholders of obtaining loans from their policy reserves.

Although there are at times abuses of policy loans by persons who mortgage the monetary value of their policies for purposes of speculation or dissipation, the granting of policy loans should by no means be abrogated. As was concluded by Professor C. K. Knight, where the mission of insurance is for family protection, policy loans should be discouraged; but where it is for business purposes, they should be freely granted, for they go a long way in meeting business needs. At any rate, from the standpoint of the company, it does not

matter if it makes a portion of its investments in the form of policy loans.

IV. Real Estate Holdings

As a form of investment for the funds of the policyholders, real estate occupies an insignificant part of the total assets of life insurance companies. In fact, the holding of real property is discouraged by many of the statutes. The restrictions placed on the ownership of real estate by the New York Insurance Law are as follows:³⁰

Every insurance corporation transacting business in this state may purchase, hold and convey real property only for the following purposes and in the following manner:

1. The building in which it has its principle office and the land upon which it stands.
2. Such as shall be requisite for its convenient accomodation in the transaction of its business.
3. Such as shall have been acquired for the accomodation of its business.
4. Such as shall have been mortgaged to it in good faith by way of security for loans previously contracted or for moneys due.
5. Such as shall have been conveyed to it in satisfaction of debts previously contracted in the course of its dealings.

³⁰

Amasa J. Parker, Jr., "Insurance Law of New York," Article II section 20, pp. 19-20.

6. Such as shall have been purchased at sales upon judgments, decrees, or mortgages obtained or made for such debts.

7. Such as shall have been acquired under sections thirteen and fourteen of the general corporation law.

Although these conditions are found in the general provisions of the New York Insurance Law, they apply to every insurance corporation including life insurance companies as well. A close canvass of these provisions will show that the holdings of real estate by life insurance companies are limited to those properties which are necessary for the convenient conduct of business and those which come into the possession of the company by way of foreclosure proceedings on mortgages or in satisfaction of debts previously contracted. If, for instance, the company is compelled to foreclose one of its mortgages, it naturally must assume title to the real estate which is involved. Or, if some one should previously negotiate a loan from the company, it would be difficult to prevent it from accepting real estate from the agent in liquidation of the debt.

As a further ^a guarantee, a domestic life insurance corporation is not permitted to exchange any of its existing real property for another of the like, or a

differant, kind, unless the latter property is a requisite for the convenient accomodation of the corporation in the transaction of its business and unless such acquisition has been approved by the superintendent of insurance. These restrictions apply with equal force to those foreign companies (companies of other states) which do business in the state under consideration. They are not allowed to acquire any real estate other than that required for the conduct of business, nor to dispose the same as the consideration in exchange for another, except with the approval of the superintendent.

Just as in acquisition, the disposition of real estate holdings not necessary for conducting the business is strictly regulated by statute. A definite number of years is specified in the law in which the company should relinquish possession of those properties which are no longer required for the convenient conduct of the business. The requirements of the New York Insurance Law stipulate that³¹

All such real property specified in subdivisions three, four, five, six and seven of this section, as shall not be necessary for its accomodation in the convenient transaction of its business, shall be sold

³¹

Ibid, pp. 20.

and disposed of within five years after it shall have acquired title to the same, or within five years after the same shall have ceased to be necessary for the accomodation of its business, and it shall not hold such property for a longer period unless it shall procure a certificate from the superintendent of insurance that its interests will suffer materially by the forced sale thereof, in which event the time for the same may be extended to such time as the superintendent shall direct in such certificate.

The strict restrictions concerning real estate holdings by life insurance companies are prescribed because of the trouble involved in the handling of the real estate business, and the abuses to which it may be exposed. Regarding the trouble involved, there are the technical and legal aspects to contend with. The evidence of ownership in real estate is a deed of some kind, but the fact that a company possesses this deed is not absolute proof of its ownership. Not infrequently a company has acquired possession of real estate only to find that the title is defective and not marketable. To constitute real ownership, therefore, there should be an abstract of title which will show the history of the real estate under observation--the changes which have been taken place in the title or any liens which may have been recorded against it. Unless the title is guaranteed by some title insurance company, the company acquiring the real estate should exercise great care in examining it.

The other objection to large holdings of real estate is due to the abuses to which it may be exposed. The return which can be realized from the investment of real estate is low. The construction of big office buildings or the purchase of extensive lots of land will mean an unnecessary tying up of capital in fixed assets. A building which is larger than necessary for the accommodation of business will result in a waste of capital which would otherwise be profitably invested in other channels. Real estate takes a long period of years before its real value can be ascertained, and possibly a profit realized. The profit is possible, because land values are subject to fluctuation, and a life insurance company is not supposed to speculate on real estate values. As a consequence, real estate as a form of investment is generally frowned upon by the insurance laws in most of the states.

Chapter VI

STATUTORY REGULATION OF INVESTMENTS:

PRESENT LEGISLATION

(Continued)

V. Stocks

Closely related to bond investments are the stock investments of life insurance companies. They are related in the sense that both are investments in securities. But beyond this they are essentially different. Bonds, we understand, are credit instruments, and generally give a definite promise to pay a definite sum, at a definite time, with a definite rate of interest, although in some cases the promise turns out to be impossible of fulfillment. Stocks, on the other hand, are merely evidences of ownership, certifying that the holder thereof possesses the privilege of participating in the risk or the varying fortunes of the business enterprise.

Unlike bonds, stocks promise nothing at all. As was maintained by Professor Huebner, they are never an investment, but always a speculation. They are inherently speculative, because they represent ownership in the business, and business is speculative. They do not prom-

ise the payment of a cent of dividend nor the return of a dollar of principal.

Such being the essential distinction between bond and stocks, there have evolved different sets of legal regulations governing the investment of life insurance funds in both these kinds of securities. In view of the great service of the life insurance business to the insuring public, and owing to the speculative nature of stock investments, the regulations concerning them are tinged with greater strictness than those pertaining to bond investments.

The New York Insurance Law, like the statutes of other states, shows a distinct effort at curtailing or prohibiting the investment of life insurance funds in stocks of other corporations transacting the same or different kind of business, and in securities whose collateral consists in part of stocks. With reference to the investment of capital, Section 100 of the Law³² expressly provides that:

No domestic life insurance corporation, whether incorporated by special act or under a general law, shall invest in or loan upon any shares of stock of any corporation other than a municipal corporation,

nor, excepting government, state, or municipal securities, shall it invest in, or loan upon, any bonds or obligations which shall not be secured by adequate collateral security or where more than one-third of the total value of the collateral security therefor shall consist of shares of stock.

As to the residue of capital and surplus above capital and deposit requirements, they may be invested in the stocks, bonds or other evidence of indebtedness of any solvent institution incorporated under the laws of the United States or of any state. This is prescribed in the general provisions of the New York Insurance Law.³³

To make the enforcement more effective, the law further stipulates a period in which acquired stocks should be disposed of, or, if not, the volume of their holdings should be reduced, subject to the approval of the superintendent of insurance. A life insurance company may enter into an agreement for the purpose of protecting its interests in securities lawfully held by it or for the purpose of reorganization of a corporation which issued securities so held, and may deposit such securities with a committee or a depository, provided that such agreement and the deposit of securities must first be approved in writing by the superintendent of insurance. Pursuant to any such agreement,

the company may accept corporate stock or bonds or other securities which may be distributed. But, and it is this point that should be borne in mind, "if any securities so received shall consist in whole or in part of stock in any corporation or of bonds or obligations which shall not be secured by adequate collateral security or where more than one-third of the total value of the collateral security therefor shall consist of shares of stock, then any stock and any such bond or obligation so received shall be disposed of within five years from the time of their acquisition or before the expiration of such further period or periods of time as may be fixed in writing for that purpose by the superintendent of insurance."³⁴

The danger to a life insurance company of an investment in the stocks of other corporations transacting a different kind of business will be appreciated when we realize the semi-public nature of the business of life insurance. If the funds of the policyholders are to be employed for the purpose of purchasing a part ownership in a different kind of business as that of a manufacturing concern, the policyholders should be prepared at all times to experience the penalties of a

losing undertaking in the same way that they will be benefited by a profitable one. While they may not share with the company in which they have insured the profits from successful stock investments, they may bear the penalty with the company when the investment courts with failure. As no dividends are paid upon the stock when such an occasion arises, the earning power of the investment is crippled. The disastrous result cannot be overestimated.

Government, state, or municipal securities or, more especially, municipal stocks are tolerated by the statute, because they are more in the nature of bonds, and the criticisms noted above cannot properly be applied.

So far, the discussion has been confined to the stock of corporations transacting business other than that of insurance. As to those requirements governing the investments in stocks of corporations doing the same kind of business as that of the insurance company itself, the Insurance Law of New York has the following to say:

No funds of any insurance corporation organized under the laws of this state shall be invested in or loaned on the stock or security of any insurance corporation, either directly, indirectly, remotely, or in any other manner whatsoever, excepting as specifically permitted hereon.

To amplify this provision, an insurance company must not invest in or loan its funds (1) on its own stock, (2) nor on the stock of any insurance corporation, (3) nor on the stock of any corporation (a) which has invested in or loaned any of its funds on the stock of any insurance corporation or (b) which has invested in or loaned any of its funds on the stock of any corporation having an investment in the stock of any insurance corporation.

Complicated as they might seem, these few parts of the provision in fact relate to one essential idea, and that is, that the funds of an insurance company should not be invested in stocks of those companies transacting the same nature of business as that of the company itself. The purpose of this regulation is to safeguard the interest of the investing corporation. For, although it is a rare coincidence that a catastrophe hazard would occur to the life insurance business as a whole, a failure in one company will generally affect the business as a whole. The presence of an unusual epidemic, for instance, will affect many companies alike. If a company's capital is tied up in the assets of other allied companies, the failure of the companies in which it has placed its investment will affect the equity of the corporation making

such investments. Just as a manufacturing company should not invest its funds in stocks of other manufacturing companies in the same field of business, so an insurance company should not place its funds in the stocks of other insurance companies.

Like the regulations relating to the disposition of acquired stock, a life insurance company which owns any share of stock or other securities other than those sanctioned must dispose of the same, as soon as it can without suffering financial loss, or not later than a date specified, or before the expiration of such further period of time as may be fixed in writing for that purpose by the superintendent of insurance.

VI. Cash in Offices and Banks

A part of the assets of life insurance companies will be found in the form of cash in offices and banks. This is the result of one or all of the following conditions:

(a) There should always be a certain amount of actual cash on hand, which is needed by the company for meeting its matured obligations, such as mortality and annuity claims, and for the defrayal of its current

expenses, such as agents' commissions and medical examiners' fees. The amount of money required may be kept in its office or deposited in ^a bank subject to check.

(b) There is always some residual money awaiting investment. It is impossible as well as unwise to invest the premium reserves or other sources of funds as soon as they come to the company. The management must take time to observe the investment market, to formulate judgments, and to select the proper investment that will not only conform to the sound principles of investment, but also suit the best interest of the company.

(c) Very often deposits are made by life insurance companies in trust companies or other institutions in order that the insurance funds may be invested in securities not tolerated by law. Trust companies are not so much hampered in their investments as are insurance companies. If the management of a life insurance company sees that it can obtain a higher rate of return through the agency of the trust company, it is justified from the policyholder's standpoint.

The bank deposits of life insurance companies may be interest bearing or non-interest bearing, or both.

Instead of keeping the cash in its own vaults, they usually deposit it in banks or other financial institutions which are willing to pay something for the use of it. This refers only to time deposits. Those which are subject to check may be interest bearing or non-interest bearing.

In well managed companies, the percentage of cash in bank to the invested assets varies with the size of the company and the form of insurance transacted. The smaller the company, the larger will be the proportion of its assets in the form of cash. Among fire insurance companies, it is not uncommon to find 10 per cent of their admitted assets in the form of cash, while normally a life insurance company would possess an amount not exceeding 5 per cent. At present the ratio is but 1 or 2 per cent.

There is no definite provision in the Insurance Law of New York which deals with the regulation of investments in cash assets, but the principle which governs the investment of life insurance funds as discussed in Chapter II above will reveal the impropriety of keeping large cash reserves. In view of the fact that the life insurance business is practically certain in its financial

obligations, it is not necessary for companies to retain large sums in cash. From an investment standpoint, a large bank account should be discouraged, for no bank can afford to pay as high a rate of interest as the company could generally realize from well-chosen investments. Except for current checking purposes, non-interest bearing accounts should be avoided as much as possible.

There are some improper conditions which may result from a company keeping too large a percentage of its assets in the form of cash in banks. It may indicate a close affiliation of the company with the financial institution. The officers of the insurance company may be interested financially in the affairs of the bank. Or possibly, the insurance company may be under some obligation to the bank, and is now liquidating its indebtedness by keeping a large deposit there at a low rate of interest. Or in the case of a newly established company, the deposit of a large volume of cash in bank is connected with the underwriting of the capital stock of the company. All these conditions it is the duty of the insurance examiner to find out when such examination is conducted.

VII. Unpaid and Deferred Premiums

Unpaid premiums refer to those premiums which have fallen due, but which have not been paid by the policyholder or reported by the agent to the home office of the insurance company. They have nothing to do with the method of payment, that is, they may be either annual, semi-annual or quarterly installments. For instance, if a policy is issued on February of a certain year on a semi-annual basis, and if an examination of the company is to be made on December 31 of the year, the premiums on the policy for the entire year will have become due before the time of the examination, for one installment is paid at the inception of the policy, that is, February, and the second installment, six months thereafter. When the premium for this second installment is not paid or reported to the home office of the company, it is considered as an unpaid premium.

Deferred premiums, on the other hand, are those premiums which are to be due, and which are necessary to complete the policy year. They may be on installments of a yearly, semi-annually, or quarterly basis. For instance, if a policy is issued on December of 1926 on the semi-annual basis, the second installment of the premium will be due in June of 1927. If an examination is to be made of the company as of December 31, 1926,

there will be one semi-annual premium deferred, namely, the premium which is due the following June.

Taking December 31 as the date for the examination of the company, we can multiply examples after examples showing when and how are premiums regarded as being deferred.³⁶ On any policy with semi-annual premiums, issued before July, there is no deferred premium, because the premiums for the entire policy year will have become due before the time of the examination. A policy, however, which is issued July of that year, will have its second installment due in January of the next year, and consequently there will be one semi-annual premium deferred. In the same way, a policy which is issued in the month of January, February, or March on a quarterly basis has no deferred premium, because all quarterly installments become due before the date of the examination, December 31; but a policy issued during October, November, or December will have three quarterly premiums deferred.

The Insurance Law of New York is virtually silent on the subject of unpaid and deferred premiums of life insurance companies. Nevertheless, a policy may have

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For a full discussion of the manner in which deferred premiums are computed, see S. H. Wolfe's tables and explanation in his book, "The Examination of Insurance Companies," pp. 57-60.

credits for both these items. It is proper to allow them as credits, for the calculation of the reserve is based upon the assumption that all of the premiums are paid at the beginning of the policy years. But inasmuch as the reserve is computed upon the net premium basis, we should deduct the element of loading from the uncollected and deferred premiums. This will place the asset which we allow as an offset upon the same basis.

Generally assets in the form of unpaid and deferred premiums are insignificant in character. Too large a percentage of this item will indicate a marked weakness from the asset standpoint. As a consequence, such unpaid and deferred premiums represent but two per cent of the total assets of life insurance companies today.

VIII. Collateral Loans

Among the other assets of life insurance company are collateral loans. These are loans made to an individual, a firm, or a corporation upon its note secured by the deposit of certain collateral, which may consist of bonds, stocks, or mortgages.

Generally speaking, collateral loans are not favored by statute. For, as a form of investment, they really

belong more properly to banking institutions than to insurance companies. A life insurance company, like other insurance institutions, should not be burdened with the necessity of looking after the securities which have been pledged as a security for the loan. They may have such constantly fluctuating prices that the company must keep in constant touch with the security market in order to ascertain their worth and ^{to} safeguard its financial position.

It is but natural that the Insurance Law of New York prohibits the making of any loans by domestic life insurance companies upon any kind of collateral in which they would not invest their funds. The provision relating to the investment of life insurance funds in stocks as above discussed applies with equal force to the making of loans whose security is in the nature of stocks. To reiterate, let us quote again section 100 of the Insurance Law of New York.

No domestic life insurance corporation, whether incorporated by special act or under a general law, shall invest in or loan upon any shares of stock of any corporation, other than a municipal corporation, nor, excepting government, state or municipal securities, shall it invest in, or loan upon, any bonds or obligations which shall not be secured by adequate

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Amasa J. Parket, Jr., "Insurance Law of New York," pp. 134.

collateral security or where more than one-third of the total value of the collateral security therefor shall consist of shares of stock.

The fact to be noticed in this provision is the expression "or loan upon" following the words "invest in." The reason for such regulation of collateral loans is not difficult to see. For, should the borrower fail to pay his note upon its due date, the company would have to fall back on the collateral in satisfaction of its loans to the borrower. Inasmuch as the risk of stock investments is ever present, we can readily see the undesirability of making loans whose collateral securities are in the form of stocks.

On the other hand, whatever security is permitted for the investment of funds by life insurance companies is also recognized as good collateral for the making of loans. In fact, some of the regulations regarding the investment of life insurance funds contain such words as "....may be invested in or loaned on...." The provision prescribing the investment of the residual capital and surplus funds of insurance companies is a case in point. It states as follows.

The residue of the capital and the surplus money and funds of every domestic insurance corporation over

and above its capital and the deposit that it may be required to make with the superintendent, may be invested in or loaned on the pledge of any of the securities in which deposits are required to be invested or in the public stocks or bonds of any one of the United States, or in bonds and mortgages on improved unencumbered real property in this state worth fifty per centum more than the amount loaned thereon, or except as in this chapter otherwise provided, in the stocks, bonds or other evidence of indebtedness of any solvent institution incorporated under the laws of the United States or of any state thereof, or in such real estate as it is authorized by this chapter to hold.

It is unnecessary to enumerate all the securities in which collateral loans may, or may not, be made. The two extracts cited above from the Insurance Law of New York will suffice to bring home the point involved.

Chapter VII

RECENT STATUS OF LIFE INSURANCE INVESTMENTS

In the preceding chapters, we have made in general a survey of the past statutory regulations of the investments of life insurance companies, and in particular an analysis of the present legislation and the character of such investments as they exist today. In order to appreciate more fully the efficacy of legislation upon the life insurance business so far, it is necessary to turn to a discussion of the recent status of investments of life insurance companies in the light of investment earnings, investment costs, and the general tendencies of the growth and development of such investments.

I. Investment Earnings

The investment earnings or the rates of interest earned on money invested in securities or other channels constitute one of the most important subjects in the life insurance business. The investment of the mammoth funds of life insurance companies would not have attained such supreme importance and claimed such

zealous attention on the part of the companies themselves or of the public if it were not for the amount of compensation--the interest or dividend earnings--obtainable from such investments. Every party concerned is directly or indirectly interested in seeing that the investment earnings of life insurance companies are not only reasonable but also remunerative: the company, because its success in the transaction of its business on a sound financial standing is at stake; the policyholders, because their equity is dependent upon the success of the company; and the financial world at large, because there exists a closely-knit relationship between the different units of the financial structure.

The importance of investment earnings grew with the development of the insurance business. When life insurance was first written in this country, term insurance constituted the prevailing form of policy contract. With it, the rate of interest was not a prime factor, because the policy term under the contract was of short duration, and the small amount of money held by the company on account of it, was retained only for a short period of time. With the appearance of life payment policies, the cost of such policies was affected materially by the rate of interest, but still the average rate of interest

was not so important as it is at present. With the advent of endowment and limited payment policies which involved a large element of investment, the rate of interest became one of the essential factors in the cost of such policies. Companies of today must exercise care and caution in handling their investments, so that they will not only be able to meet their obligations when the policies mature, but also to earn a fairly good rate of return.

Let us now examine briefly the investment earnings of American life insurance companies as regards, (1) the rate of interest assumed, and (2) the actual interest earned.

As we understand, in the calculation of premiums for life insurance policies, a certain rate of interest is assumed at which a company is able to earn on the funds under its control. To guarantee the assumption of a conservatively low rate, state statutes have prescribed maximum rates for valuation purposes.³⁹ As early as 1857 the State of Massachusetts passed a law requiring companies to assume a rate of 4 per cent as a basis for

computing their reserves. By 1862, eleven of the seventeen companies operating on a level premium plan were on a 4 per cent basis, three on a 5 per cent basis and one on a 6 per cent basis. The high rates of interest assumed were due to the high interest rates of the Civil War Period. After 1873 there was a decided tendency to assume a 4 per cent basis on account of the hard times of this period. Before the opening of the nineteenth century, however, there was no state which required a $3\frac{1}{2}$ per cent basis, although at the present time practically all business is written on either a $3\frac{1}{2}$ per cent or 3 per cent basis. An investigation of a number of companies as reported in the Insurance Year Book selected at random will show that most companies have adopted $3\frac{1}{2}$ per cent as a basis for computing their premium rates.

Turning to the history of the actual rates of investment earnings, ⁴⁰ we find that in 1859 seven level premium companies were actually earning a rate of from 5.4 to 6.4 per cent. The rates during 1860 to 1870, the Civil War Period, were the highest of any decade in the history of insurance. Eleven companies earned above 10 per cent, seven between 9 and 10 per cent, thirty-seven between 7 and 8 per cent, and forty between

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Ibid, pp. 219-220.

6 and 7 per cent. The average earning of all companies from 1870 to 1880 was above 6½ per cent, despite the hard times of the period and the failure of many companies. After 1880, the decline in average earnings began and no company maintained a level earning of 6 per cent. From the years 1899 to 1908 inclusive, the average rate of interest earned by twenty-five leading companies was 4.68 per cent. Since then, there has been a tendency to increase slightly, but on the whole the average has been less than 5 per cent since the late nineties. The average rate of interest earned on mean invested funds by seventy-one life insurance companies was 4.79 per cent from 1909 to 1913, 4.89 per cent from 1914 to 1918, and 5.19 per cent from 1919 to 1923, or an average of 4.95 per cent ⁴¹ for the two decades prior to 1924.

The history of the rate of interest assumed and the rate actually earned by life insurance companies serves to show that they obtain on an average very satisfactory interest returns on their funds. Whereas in former years the assumed rate of interest was high and the rate actually earned was also high, at the present time, the assumed rate is low and the rate actually earned is also

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From the 1924 Insurance Year Book (Life volume), pp. A-500.

low. There has been almost always a difference of from one to two per cent between the rate assumed and the rate actually earned. That is what should be expected, for the assumed rate is the minimum rate which the companies guarantee will earn on the funds under their control. If they diversify their investments without departing from the principles governing them, the rate they actually earn will naturally exceed the rate assumed.

So far we have been discussing investment earnings from the viewpoint of the rate of interest earned on the invested assets as a whole. No attempt has been made to ascertain the earnings on specific investments, for it would entail too lengthy a discussion than the space here will provide. Suffice it to say, the aggregate figures for the combined assets of the life insurance companies show that on the average the returns from investments have been fairly constant.

II. Investment Costs

It would be illuminating, however, to find out the amount of investment earnings that the companies have been able to net on their investments. Before doing so, we must first ascertain the costs or expenses which must be defrayed in the making of investments.

At the outset, we should determine the part of the financial statement of^a life insurance company to which the investment expenses should be allocated. Insurance men are all in unison that such expenses are excluded from loading. Our knowledge of the gross premium is that it consists of two parts: the net premium, or that portion of the premium which takes care of policy claims; and the loading, or that portion of the premium which provides for expenses. The loading covers expenses incurred in writing and caring for insurance policies, such as acquisition expenses, advertising costs, medical examiners' fees, renewal expenses, home office expenses, taxes, etc.

In view of their exclusion from loading, investment expenses are allocated to the gross earnings from investments. It is not customary to consider all gross earnings as earned, and to distribute all such earnings as the management sees fit. Instead, investment expenses are deducted from gross investment earnings or gross income from investments. This practice is true in the United States as well as in most countries.

In an analysis of investment expenses, we find that they are composed of several factors, chief among which are the cost of making, handling and protecting investments, bad debts resulting from such investments, losses

over gains arising from unprofitable investments, and
⁴²
 taxes and repairs on assets.

Taking these factors as a whole, it might be said that the investment expenses are mainly devoted to the care and investment of assets, including necessarily incidental losses and taxes and repairs on real estate. As was urged, the expenses of officers and clerks employed in this branch of business should be provided for, and should be met out of the gross interest and rents earned on total assets, by assuming a lower rate of interest for computing net premiums and reserves.⁴³ For instance, if $3\frac{1}{2}$ per cent is the maximum gross rate which can be safely relied upon during a long period, say, twenty or thirty years, the net rate used should be about 3 per cent. Thus it will leave a margin of $\frac{1}{2}$ per cent for the defrayal of the various items included under investment expenses. It was further argued that actuaries are a unit as to the appropriateness of such an arrangement.

Investment expenses vary with the amount of the

⁴²
 W. D. Whiting, "Provision for Expenses," in L. W. Zartman's "Yale Readings in Insurance," (Life), pp. 177.

⁴³
 Ibid, pp. 180.

total assets. It is estimated that the amount of investment expenses paid by life insurance companies on their investments represents approximately one-half of one per cent on assets per year, although in some cases it may be above or below this rate. Taking the state of New York as an illustration, we find that thirty-eight companies (15 New York State companies and 23 companies of other states doing business in the State of New York) reporting to the Insurance Department of that state show an aggregate investment expense of \$29,277,142⁴⁴ for the year ended December 31, 1924. The amount of interest earned totaled \$445,181,755, thus leaving a net income from interest to the amount of \$415,903,613. As the interest required to maintain the reserve is valued at \$257,150,905, the gain from interest and rent is in fact \$158,752,708. The aggregate assets for the same companies amounted to \$9,807,769,626. The investment expenses, therefore, constituted about one-third of one per cent of the total assets. A closer scrutiny of the New York Life Insurance Report will reveal that these companies reported a total gain from investments of

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Complete data for the United States as a whole were not available. The figures quoted here and those following were taken from the "Sixty-sixth Annual Report of the Superintendent of Insurance, State of New York," 1925, pp. XLII.

\$46,290,150, and a total loss from investments of \$15,655,655, leaving a net gain from investments of \$32,637,495.

The figures, though representative of conditions in the State of New York, are nevertheless typical of the companies in the United States as a whole. Regardless of absolute figures pertaining to the investment earnings and investment costs, the ratio of investment expenses to the total assets of life insurance companies is approximately correct; that is, it remains approximately constant at one-half of one per cent.

III. Recent Tendencies of the Growth and Development of Investments

Having discussed the investment earnings and investment costs of life insurance companies, we may now note some of the recent tendencies of the growth and development of the investments of these companies. In Chapter IV., where the historical development of statutory regulations is treated, we referred to the extent of life insurance investments up to the first decade of the present century. We shall now trace briefly the growth of the investments since the beginning of the second

decade until the close of the last year.⁴⁵

The explanation is based upon the aggregate records of 52 leading life insurance companies which contributed their investment data to the Association of Life Insurance Presidents. These companies hold 93 per cent of the total funds of all the companies in the United States, and the figures which follow cover the period from 1911 to September 30, 1925.

For purposes of illustration, the following two charts are reproduced here. (See next two pages.) The top line in Chart I represents the total funds of the 52 companies under consideration, showing the growth from \$3,881,260,000 to \$10,381,108,000 from the year 1911 to 1925. Chart II attempts to show the variations in the proportions of the different kinds of investments.

Turning to Chart II then, the first item is designated as "all other admitted assets." It includes collateral loans, cash, and other investments comprising all non-classified matter. As a whole, this item has

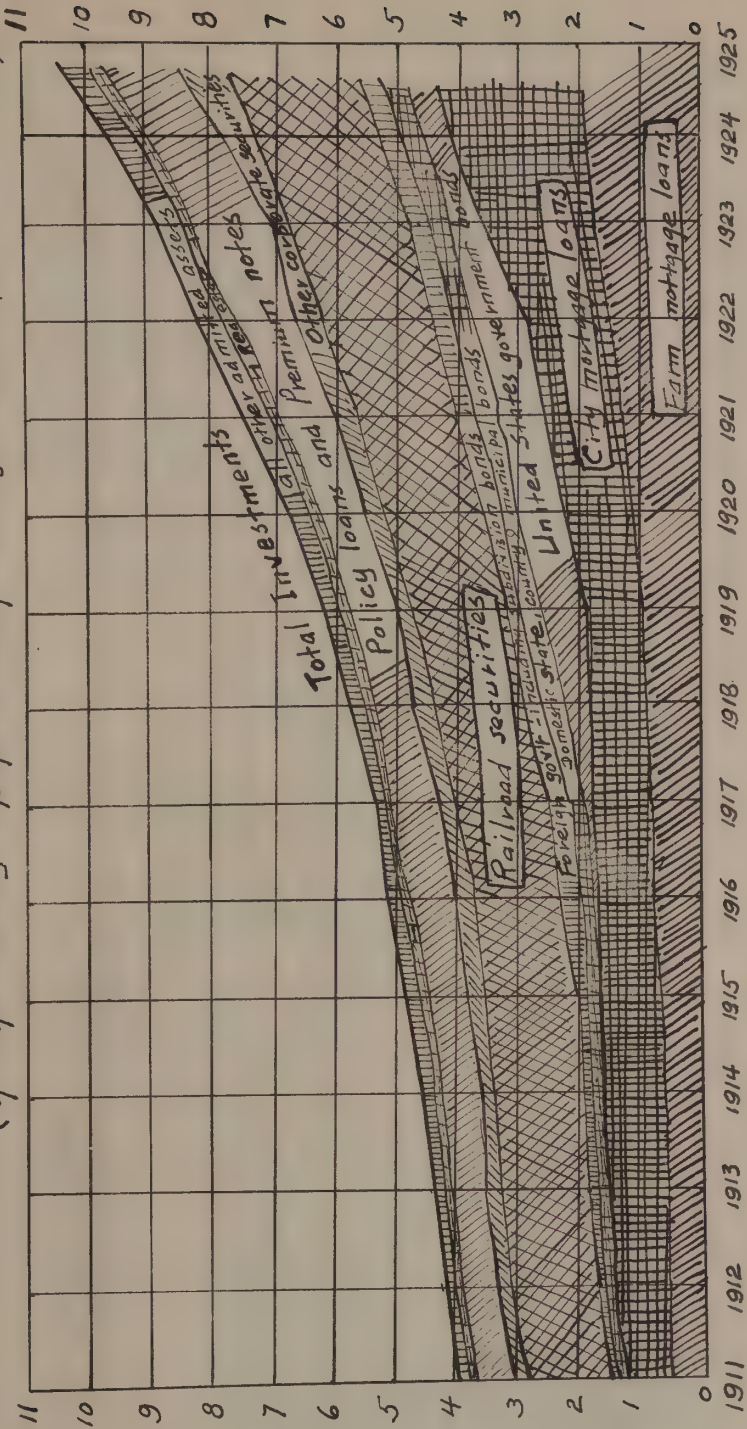
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The information is taken largely from the address, "The Response of the Life Insurance Companies to the Nation's Demand for Funds" by Mr. Robert W. Huntington, President of Connecticut General Life Insurance Company, made before the nineteenth annual meeting of The Association of Life Insurance Presidents in New York, December 3-4, 1925.

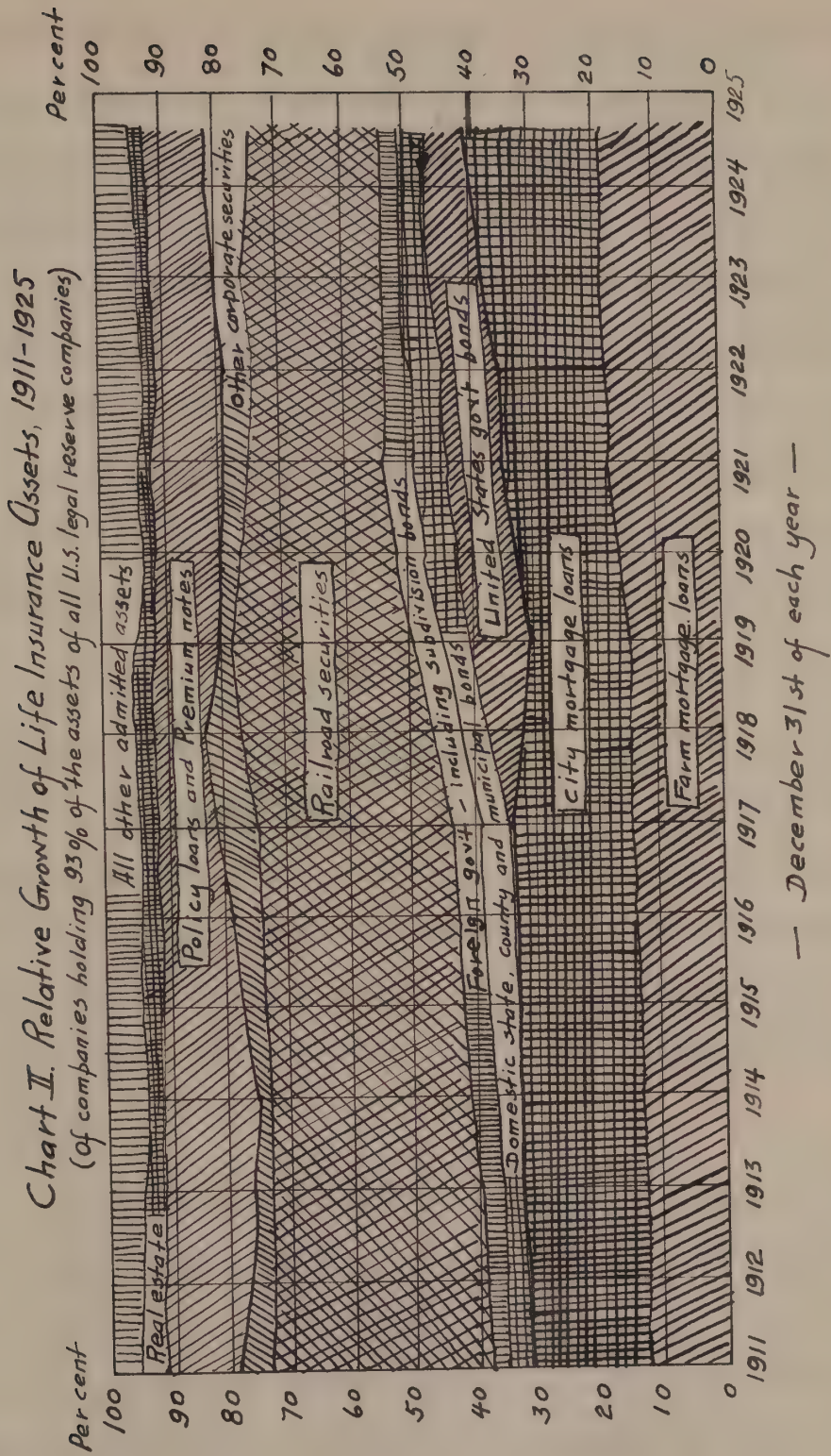
Chart I. Absolute Growth of Life Insurance Assets, 1911-1925
 (of companies holding 33% of the assets of all U.S. legal reserve companies)

Billions
of dollars

Billions
of dollars



- December 31st of each year -



varied little in proportionate amounts for the fourteen years, the ratio changing from 4.4% in 1911 to 5.3% on September 30, 1925. Collateral loans started with \$12,483,000 and ended at \$13,576,000; cash increased from \$59,737,000 to \$116,492,000, but decreased in proportion from 1.5% to 1.1% of the total assets; and the rest went up from \$98,494,000 to \$403,068,000, an increase of from 2.6% to 4%. The important point to be noticed is that the tendency of late years seems to be to carry proportionately less cash than was formerly.

Real estate increased absolutely from \$151,762,000 to \$186,058,000, but decreased relatively from 3.7% to 1.8% of the whole for the years 1911 and 1925 respectively. By far the greater part of this investment is in office buildings for the company's use, the remainder being mostly in the form of foreclosed properties. This is in line with the legal restrictions on real estate holdings.

Likewise premium notes and policy loans ascended in actual amount from \$505,610,000 to \$1,271,060,000, but fell in percentage from 13% to 12.2%. The percentage is out of the direct control of the companies, and may be expected to decrease when money is easy (and vice versa).

The remainder of the assets are divided into two great classes--bonds and stocks, and mortgage loans. In the former category, railroad bonds and stocks are by far the most important. They started in 1911 with \$1,303,537,000, or 35.7% of the total assets, and have gone up in amounts but decreased in relative importance until on September 30, 1925 they amounted to \$2,194,752,000 or 21.1% of the total investments. The growth has been in keeping with the development of the railroad industry of this country, but the relative decrease may be due to a multiplicity of causes, among which are the decreasing ratio of new railroad construction and the increasing demand for funds by other industries needing development.

As to the various kinds of government bonds, the amount of United States government bonds at the beginning of the period was negligible. It stood, however, at \$652,313,000 or 6.3% of the total in 1925, although a high amount of \$706,063,000 was reached in 1919 and of \$821,003,000 in 1922. It shows how promptly the life insurance companies responded to the demand of the country for funds to carry on the war. On the other hand, the amount of state, county, and municipal bonds decreased from 4% to 3.2% of the total, while foreign government bonds from 1.6% to 4/10 of 1%.

"Other bonds and stocks" had increased both in actual and relative amounts, the figures being \$122,852,000 and \$712,195,000, and the percentages 5.2% and 6.9% respectively for 1911 and 1925. Of this amount, \$568,421,000 was in the securities of public utilities, the investment in which has increased 118% in the space of two and three quarter years. The funds so advanced are used to finance telephone, telegraph, gas, electric power, water, and other public utility companies contributing to the recent phases of American progress.

The bonds and stocks comprise at the present time 40.2% of the total, compared with the high of 47% of the total fourteen years ago. While mortgages represent 40.6% of the total in 1925, in contrast with the 31.7% of 1911. Farm loans started with \$430,826,000 or 11.1% of the whole, compared with \$727,473,000 of city loans or 20.6% of the whole. At the close of September, 1925, the former reached as high as \$1,871,056,000 or 18%, while the latter \$2,346,674,000, or 22.6%. Loans on city property have more than doubled in less than five years, which fact reflects clearly the recent construction programs relieving the housing shortage and caring for business expansion. Life insurance companies have met the demand by the cities for money to complete their

building projects, which had been held up by the war.

To sum up the recent tendencies of the growth and development of life insurance investments, I can do no better than to quote the words of R. W. Huntington, President of the Connecticut General Life Insurance Company:

Public utility securities and city mortgage loans show the largest increases in this year's [1925] investments of life insurance funds....., while holdings in government and municipal bonds are now on the decrease, revealing the trend to other types of investment. Loans to policyholders are still increasing in amount but have shown a steady reduction since 1921 in the percentage of total investments of the companies, and indicate improvements in the economic status of policyholders. Farm mortgages and railroad bonds are increasing in amounts but not so rapidly as other holdings of the life companies and both of these classes now show decreases in the percentage of total life insurance investments.

Chapter VIII.

SUMMARY AND CONCLUSION

I. Resume

In this thesis, the writer has attempted to discuss one of the most important phases of the life insurance business--the investment of life insurance funds. The subject merits intensive consideration, because of the enormous magnitude of funds in the possession of life insurance companies. The investment of such funds is a matter of serious concern, not only to the companies themselves, but also to the insuring public and the financial world at large. The object of the business of life insurance is by no means confined to the mere vision of dollars and cents, but extends beyond to the noble ideal of service to mankind.

There are certain primary principles which should be observed by companies in making their investments, if their integrity is to be safeguarded and the equity of the policyholders to be protected. The encroachment of legislation upon this field, as in many other forms of business activities, was largely the result of the growth of abuses which tended to jeopardize the

safety of companies and to threaten the welfare of the public.

The institution of life insurance is little understood by the rank and file, although it has been in existence for many years. In regard to the equities of the business, the public is helpless; and in respect to a quick test of solvency, it has no power whatever.

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As L. W. Zartman states it:

In most business a wrong step shows immediate effect and compels an immediate correction, but in life insurance a fatal error may be made and yet no signs of it appear for years so far as ability to pay present claims is concerned. On these considerations, it seems evident that the influence on the part of the government in insurance affairs is not only justifiable, but that it is a matter of duty.

The enactment of legislation in the middle of the nineteenth century resulted not so much from the fact that it foresaw abuses that might arise as from the fact that it aimed to prevent a repetition of offenses already committed. State after state left the business untrammelled until abuses became serious, and the legislative bodies began to conceive the idea that the evils could be eliminated by regulating investments.

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L. W. Zartman, "The Investments of Life Insurance Companies," pp. 175.

So for more than half a century the states have been trying to regulate the business of life insurance. Up to the close of the first decade of the twentieth century, the evolution of the different bodies of state statutes has been a gradual and complicated one. It was said that before 1905 the State of New York had seen fit to amend her law regulating investments twenty-one⁴⁸ times. Usually the regulations have simply restricted investments to certain classes of securities. Many attempts have been made, however, whereby the territorial limits within which the investments must be made were prescribed. Some laws compelled investments to be made in certain localities, particularly in the state in which the companies had their domicile. This type of legislation was inspired by selfish motives, the idea being to help out the commercial interests of the state enacting such legislation. The Robertson bill of 1907 in the State of Texas,⁴⁹ for instance, is an extreme example of state regulation of investments typical of the motives behind it.

The present legislation in the United States, using

⁴⁸
L. W. Zartman, "Yale Readings in Insurance," (Life), pp. 312.

⁴⁹
Ibid, pp. 316.

New York State as a typical illustration, has demonstrated a more and more liberal tendency on the part of the state in the regulation of the investments of life insurance companies. State boundaries have been overstepped, and on the whole, the tendency has been to allow companies a much wider field of investment.

II. Results and Achievements

Now, how much of all this legislation is sound and efficient; how much of it is unsound and inefficient? How much of it is in the right path and has accomplished and will accomplish good results; how much of it is in the wrong track and has caused and will cause serious injury? These are questions of paramount importance which confront every one affected with an interest in the business of life insurance--the insurance companies, the public, and the state.

We have repeatedly dwelt upon the necessity for state regulation of the investments of life insurance companies in this country, and we have further noticed that such regulation has had two objects in view: (1) the securing of publicity, and (2) the securing of investments of assets in certain classes of safe securities.

Publicity of the investments has not secured as great results as might have been expected. One reason might be that the published annual reports have not always been a true index of the companies' condition. Although the fault lies primarily with the companies and the state, the apathetic public should share a part of the blame, inasmuch as it has shifted all obligations to the state to see that the companies are under sound management and in accordance with sound insurance principles. The other reason is found in the fact that the possession of an enormous amount of assets by the companies speaks for the difficulty of interpreting the same fully and adequately to the public. A list of the stocks and bonds owned by a company can be printed and the public can examine it for itself. As to other items of a financial statement, such as mortgage loans, the published report can give little idea of the real value of the investment. The state should assume greater responsibility in seeing that all parts of the assets are secure. The New York Superintendent of Insurance may now investigate the security or value of property on which mortgage loans are placed. Undoubtedly the same may be practiced by other states.

The other object of legal regulation has been to

secure safety of the assets by limiting the power of the companies in the investment field. It is indeed difficult to learn the effect of legislation defining legal investments. There have been wholesome as well as pernicious effects. They were enacted to prevent a recurrence of abuses already committed, but evils have not been found wanting after their passage. In states where the most rigid legislation is enforced, companies have lost money on investments in unsafe securities. On the other hand, legislature has gone a long way towards retarding detrimental influences, strengthening the equity of companies, and enabling them to secure fairly constant investment earnings.

III. Suggestions

There are some who assert that the liberality of legislation really accounts for its imperfections, and that much of the abuses still existing would be removed, if the states would specify certain securities in which the companies could invest, instead of prescribing certain general classes of securities.

Such kind of law would greatly restrict the field of investments by life insurance companies. The best

that the government can do is to lay down some general types of investments rather than to prescribe specific securities in which life insurance companies must invest their funds. To quote a passage from the article,

"Regulating the Investments of Insurance Companies" from
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the Outlook:

It is quite proper that the law making power should carefully regulate the financial operations of insurance companies, for they are trustees for the people, and they should be inspected and regulated by law like trustees under a will. They should be told that they must invest the funds intrusted to their charge only in certain kinds of securities and financial operations. But this is so far as the legislature should go. If the legislature attempts to say, "you must put so much of your trust funds in this kind of a security and so much in that kind of a security," the legislature then supplants the trustee and become sole trustee itself. It is not the function of the legislature to determine the details of such investments. No legislature has the time or capacity for such work. Its function should be regulatory and investigatory only..... He can only say to the trustees of insurance companies, "you must be honest and open; your investments when inspected must prove to be sound; and you must not use the funds of your beneficiaries in speculative purposes; therefore, there are certain classes of investments to which we limit you, but within those classes you are to use your own best judgment as to the character, the amount, and the location of the investment.

In fact, there are good reasons to believe all legal regulation of the investments should be removed, as suggested by some writers, and more freedom granted

to the companies in making their investments.

In the first place, "a limitation of the investment field will not necessarily bring safety, and it involves a reduction in the earning power of the assets."⁵¹ It should be realized that there is no class of investments of which all in the class are good, and that there are poor and unsafe investments in every field. The best stocks are better than many bonds. Mortgage loans have been used for speculative purposes. There are good securities in all classes, which should not be lost sight of by companies when making their investments. If they are confined to certain classes of securities, they may be compelled to purchase poorer securities in those classes instead of getting the best in other classes. Moreover, the competition for the particular classes will be so keen as to drive the rate of interest down. It would make insurance more expensive to the public, a condition hardly desirable. The history of life insurance investments shows that the wise manager of insurance funds will scatter his investments. This cannot be done if the states restrict investments narrowly to certain classes.

In many respects, legal regulations of the life

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L. W. Zartman, "The Investments of Life Insurance Companies," pp. 184.

insurance business is ineffective to prevent abuses, and to that extent, as is argued, the laxity of state regulation is highly desired. It might be possible to pass an act allowing companies to invest their temporarily idle funds by buying bills, that is, bank acceptances. The Wall Street Journal of December 3, 1925, in a commanding article described the movement to the following effect:

In an effort to broaden still further the American bill market, a movement is under way to empower insurance companies operating in this state (New York) to invest in bankers' acceptances. In the law no provision is made to this end, although bankers maintain this kind of investment would afford a profitable return on temporarily idle funds of these companies. It is proposed to have an enabling act passed at Albany.... The risk, of course, is no greater than any ordinary deposit risk, and there is no reason why the acceptances of any bank should not be purchased for short time investment of funds whose standing is such that the purchaser would be justified in using such bank as a depository.

A law as is now contemplated would not require insurance companies to invest their funds in bankers' acceptances under any circumstances, but would merely put them in a position to do so whenever it was distinctly to their advantage in the opinion of their own managements to make such investments..... They would not, therefore, need to change their policy of investment in any particular, unless their study of the acceptance markets should lead them to see an advantage in doing so. There would seem to be no reason, therefore, why the insurance companies themselves should object to the passage of an enabling act, as they would have everything to gain and nothing to lose.

Whether the measure will receive the endorsement of the state government or not, the plan reveals the flexibility of legislation by which life insurance investments may be governed.

Undoubtedly the repeal of the existing law regulating investments as advocated by some writers is indeed a radical measure. Our legal statutes governing the investments of life insurance companies have had an existence of more than half century. The fact that our life insurance companies--our legal reserve companies--have attained such a remarkable record of success for the past decades, vying, if not surpassing, other financial institutions in strength and supremacy augurs highly of every justification in the preservation of the legal regulations hitherto existing. Our problem is not to destroy the results of our years of effort in attempting to regulate the business, but to preserve it and to perfect it. If we are ever to have a comprehensive solution of the problem of legal regulation of the insurance business in this country, it will have to come through the cooperation of not only the state, but also of the companies themselves and the public at large. Each party must do its share, and assume its rightful responsibility.

There should be a more efficient organization by the states of their supervisory departments of insurance. On the one hand, more laxity should be shown by legislation towards the regulation of life insurance investments. On the other hand, more strict and close supervision of the conditions and reports of companies should be enforced. State officials must be secured who are able and courageous enough to investigate the true status of the companies, and having once accumulated the facts, the state should make them common property so that an intelligent opinion can be formed.

The public likewise should be conscious of the nature and practice of the business of life insurance. Instead of being lulled to sleep and placing complete dependence upon state supervision, it should take a lively interest in the affairs of the companies transacting such business. They must not get the false impression that their interests are safeguarded when in fact they are not. If a company is engaged in stock speculation, or in the promotion of new enterprises, or in the underwriting of securities, or in any way conducting transactions detrimental to the interest of the company, the public must know it and the present and

prospective policyholders must find an explanation for it. They must ever bear in mind that the institution of insurance is their benefactor, and that, like other kinds of beneficiaries, they should have an interest in the affairs of those which exist for their benefit.

Finally, the responsibility of securing sound and efficient investments falls upon the companies themselves, since their own interest is at stake. The officers of such companies must not entertain the notion that they have done their duty to the investments when they have not stepped out the boundaries set for them by law, when in fact they could have done much better toward getting safer and more remunerative investments. Very often, the fault lies not with the investments, but with the management controlling the assets. With the greater freedom of investment should come changes in the methods of management of the companies. The management should see to it that the huge assets of the company are placed under the control of the right functionary. If a right sense of responsibility is intelligently applied and carried out, the question of legal enactment may be subsidiary. If the state fulfills its duty in finding out precisely what the management of a company is doing and in publishing the facts which it

learns, and if the policyholders have registered their interest and found an easy and effective method of expressing their will to bring pressure to bear on the companies, most officers of insurance companies would be deterred from mismanagement. Let every affected interest cooperate to uplift the business of life insurance so that it will not only maintain the position which it has enjoyed, but also attain a higher plane of supremacy in the whirlpool of the financial world.

It is certainly the pride of life insurance companies not only to respond promptly to the nation's demand for funds by way of extensive investments, but also to supply the needs of the country at the right time and in the right place. During the war when much construction work in the city was impracticable, the companies reduced their city loans and turned their attention to farm mortgages. Since the war, when the building programs were commenced, they reverted their investments, and placed their funds heavily in city loans. Likewise in the railroad development of the country, the companies furnished the money when it was most needed. So it is with the public utilities at the present. Whatever changes may come in the future economical development of the country, they will be easily assimilated,

because the life insurance funds, contributed in small mites by millions of policyholders, will be ready to meet the needs at all times.

How much of the statutory regulation has affected the actual investments of life insurance companies it is difficult to state. But the cooperation of every interest concerned--the state, the public, and the companies themselves--will incontrovertibly direct the flow of the investment of life insurance funds to those channels that will yield the maximum return to the companies and redound to the greatest benefit of the country.

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